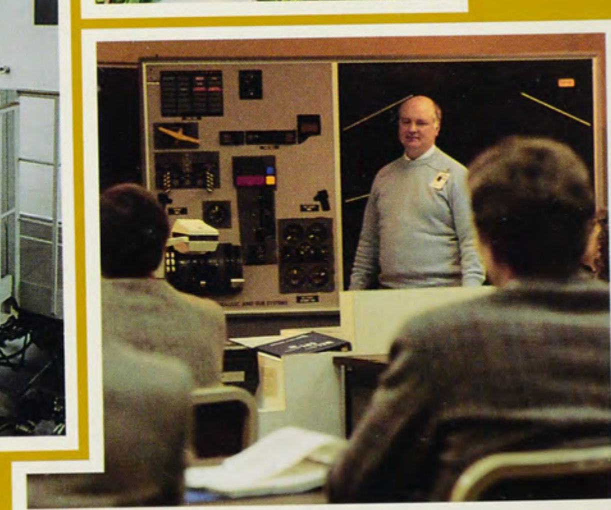
Republic Airlines
1985 Annual Report

ABOUT THE COVER: Republic's Boeing 757s entered service in 1985. A "good neighbor" jetliner, noted for quiet operation, they are powered by fuel-efficient Rolls-Royce engines. They are used principally on long-haul routes from Detroit to the West Coast.

Republic's Travel Agency Advisory Board meets quarterly to ensure a quality relationship with the airline's partners in travel. Republic's personal and high-tech training programs instill pride and productivity in its employees.



Republic Airlines

1985 Annual Report

Contents

The Company

Republic Airlines, Inc. – now in its 39th year – is engaged in the business of carrying passengers on its scheduled route system. The Company began service February 24, 1948, as Wisconsin Central Airlines. In 1952, its name was changed to North Central Airlines, which merged with Southern Airways in 1979. The following year, Hughes Airwest was purchased. As one of America's 10 largest airlines, Republic now serves more than 100 cities in 34 states coast-to-coast, plus Canada, Mexico, and the Cayman Islands in the Caribbean.

Highlights

	1985	1984	Percent Increase
Financial			
Operating Revenues	**$1,734,397,000**	$1,547,232,000	12.1
Operating Expenses	**$1,568,067,000**	$1,447,230,000	8.3
Operating Profit	**$ 166,330,000**	$ 100,002,000	66.3
Net Earnings	**$ 177,006,000**	$ 29,511,000	499.8
Net Earnings per Common Share:			
Primary	**$ 4.74**	$ .76	523.7
Fully Diluted	**$ 3.98**	$ .75	430.7
Stockholders' Equity	**$ 196,081,000**	$ 8,640,000	2,169.5
Common Stock Outstanding at Year End	**33,567,000**	30,639,000	9.6
Statistical			
Passengers	**17,465,000**	15,257,000	14.5
Revenue Passenger Miles	**10,736,918,000**	8,594,040,000	24.9
Available Seat Miles	**18,267,960,000**	17,113,170,000	6.7
Passenger Load Factor	**58.8%**	50.2%	8.6 pts.
Cargo Ton Miles	**116,943,000**	94,773,000	23.4
Number of Employees at Year End:			
Full Time	**13,700**	12,900	6.2
Part Time	**1,500**	500	200.0

To our stockholders, employees and friends:

Your Company enjoyed the best financial performance in its history during 1985. Net earnings reached $177 million on operating revenues of $1.73 billion. The earnings equate to $4.74 per share (primary) — a sixfold improvement over 1984 when we earned $29.5 million or 76 cents per share (primary), with operating revenues of $1.55 billion.

For the year, passenger traffic jumped almost 25 percent over 1984 while seat capacity increased a modest 7 percent. As a result, 1985 load factor was 59 percent — nearly a 9 point improvement over the preceding year. Traffic growth exceeded 30 percent each month May through December year over year, and in October and November your Company posted the highest load factor among the major airlines.

This outstanding financial and traffic performance is the direct result of actions taken by your management over the past two years following our objective of becoming a carrier of preference. This goal involved all operational elements of the airline and resulted in a major repositioning of Republic in the intensely competitive airline industry. We have dedicated the resources of your Company to building a competitive hub structure at Detroit, Minneapolis/St. Paul, and Memphis. These hubs offer passengers the convenience of single airline service as they flow through these uncongested traffic centers. To stimulate traffic growth, we closely timed arrivals and departures at the hubs to maximize connecting opportunities for in-bound passengers. With the April 1985 schedule modification, connecting opportunities at Memphis increased 156 percent; at Minneapolis/St. Paul, 88 percent; and at Detroit, 82 percent.

Because of the increased traffic, we placed an earlier-than-anticipated order for six Boeing 757 jetliners. Three of these quiet and fuel efficient, 190-passenger aircraft already operate on long-haul flights, principally from Detroit. The remaining three 757s will join Republic by mid-1986. Republic has options for future delivery of six more Boeing 757s.

Daniel F. May

Other 1985 highlights:

- Adding eight other aircraft: three Boeing 727-200s and five DC-9s, bringing the fleet size to 168 jetliners;
- Inaugurating service at 12 additional cities;
- Signing agreements with regional airlines for passenger support at each of Republic's three hubs;
- Opening a state-of-the-art reservations center in Livonia, Michigan, a Detroit suburb;
- Completing major construction programs at key airports;
- Opening expanded Executive Suite lounges in Detroit, Memphis, and Minneapolis/St. Paul;
- Planning First Class service which was introduced in February 1986; and
- Adding front-cabin service to 33 aircraft with First Class now available on all DC-9, Boeing 727, and Boeing 757 aircraft.

We also report with sorrow the October 20 death of Eric Bramley, a director of the Company since 1976 and previously editor of *Aviation Daily*, the airline industry's leading trade publication. His contribution to the direction of your Company is gratefully acknowledged and his absence deeply felt.

NWA Inc., parent of Northwest Airlines, and Republic jointly announced January 23, 1986, an agreement for NWA to purchase Republic for approximately $884 million. The Northwest-Republic combination will produce one of America's largest and most dynamic airlines. When government and stockholder approvals are received, the resources of the combined carriers will make a formidable airline, strongly positioned for further growth.

The association of your Company with Northwest will benefit Republic's three constituencies — stockholders, passengers, and employees. As part of the agreement, NWA will pay $17 a share to stockholders. Many of those stockholders are Republic employees who as a group own approximately one-fourth of the Company. The rewards to employees result not only from the increased value of their Republic holdings, but also from the personal and professional opportunities created by the merger.

Passengers and shippers will be the real winners when the airlines combine. Single-carrier service from cities large and small will be available to a dozen destinations in the Far East and Southeast Asia, and eight in Europe. The blending of Republic's strong domestic route system with the international resources of Northwest will result in a financially strong carrier dedicated to providing quality service.

The merger process is proceeding smoothly through the Department of Transportation, and we expect government and Republic stockholder approval soon. Once these are received, Republic will be combined with Northwest Orient Airlines, offering travelers a superior network of world-wide travel convenience.

Stephen M. Wolf

We want to thank you for the support you have provided during Republic's 38-year history. It is dearly appreciated and will long be remembered.

Sincerely,

Daniel F. May
Stephen M. Wolf

Daniel F. May
Chairman of the Board

Stephen M. Wolf
President and Chief Executive Officer

March 6, 1986

Ten-year summary

OPERATIONS (in thousands, except per share amounts)	1985	1984	1983	1982	1981	1980*	1979	1978	1977	1976
OPERATING REVENUES										
Passenger	$1,598,237	$1,415,583	$1,388,285	$1,402,693	$1,311,951	$827,678	$527,792	$408,243	$317,469	$272,365
Other	136,160	131,649	123,209	127,975	136,465	89,037	81,438	79,322	71,165	58,950
	1,734,397	1,547,232	1,511,494	1,530,668	1,448,416	916,715	609,230	487,565	388,634	331,315
OPERATING EXPENSES	1,568,067	1,447,230	1,542,511	1,493,445	1,431,960	903,491	581,177	444,756	360,839	312,024
OPERATING PROFIT (LOSS)	166,330	100,002	(31,017)	37,223	16,456	13,224	28,053	42,809	27,795	19,291
OTHER EXPENSES (INCOME)										
Interest expense–net of capitalized interest	90,092	97,000	97,852	100,703	108,362	48,341	20,122	16,673	11,476	9,347
Gain on disposition of property, equipment and lease rights	(21,368)	(17,316)	(923)	(2,570)	(13,369)	(4,112)	(2,002)	(1,306)	(8,904)	(280)
Other income–net	(21,925)	(9,193)	(16,915)	(21,049)	(32,326)	(4,403)	(1,378)	(2,593)	(700)	(924)
	46,799	70,491	80,014	77,084	62,667	39,826	16,742	12,774	1,872	8,143
EARNINGS (LOSS) BEFORE INCOME TAXES AND EXTRAORDINARY ITEMS	119,531	29,511	(111,031)	(39,861)	(46,211)	(26,602)	11,311	30,035	25,923	11,148
Income tax credit (expense)	(50,300)	(15,802)	–	–	(58)	1,940	1,750	(5,464)	(2,885)	(3,144)
Extraordinary items										
Effect of utilization of tax loss carryforwards	45,600	15,802	–	–	–	–	–	–	–	–
Gain on pension plan termination	62,175	–	–	–	–	–	–	–	–	–
NET EARNINGS (LOSS)	$ 177,006	$ 29,511	$ (111,031)	$ (39,861)	$ (46,269)	$ (24,662)	$ 13,061	$ 24,571	$ 23,038	$ 8,004
NET EARNINGS (LOSS) PER COMMON SHARE										
Primary	$4.74	$.76	$(4.28)	$(1.99)	$(2.30)	$(1.19)	$.70	$1.42	$1.38	$.48
Fully diluted	$3.98	$.75	$(4.28)	$(1.99)	$(2.30)	$(1.19)	$.68	$1.31	$1.23	$.43
OTHER FINANCIAL DATA (in thousands, except per share amounts)										
Current assets	$ 528,285	$ 302,796	$ 263,067	$ 328,640	$ 263,296	$ 249,010	$144,691	$107,764	$ 89,088	$ 71,362
Property and equipment–net	$ 738,332	$ 761,678	$ 829,830	$ 846,036	$ 882,196	$ 778,375	$399,632	$314,054	$235,671	$195,807
Total assets	$1,286,297	$1,084,909	$1,108,672	$1,186,174	$1,154,567	$1,036,226	$549,381	$428,424	$330,336	$271,536
Total long-term debt and capital lease obligations	$ 633,659	$ 675,215	$ 759,395	$ 797,287	$ 722,434	$ 652,257	$263,035	$196,637	$142,648	$129,512
Redeemable preferred stock of subsidiary	–	$ 28,000	$ 28,000	$ 28,000	$ 28,000	–	–	–	–	–
Stockholders' equity (deficit)	$ 196,081	$ 8,640	$ (22,381)	$ 27,938	$ 72,348	$ 117,627	$145,514	$113,288	$ 89,266	$ 67,247
Cash dividends per share of common stock	–	–	–	–	$ .10	$ .20	$ .20	$ .16	$ .12	$ .10
STATISTICS										
Passengers	17,465,000	15,257,000	17,787,000	18,075,000	16,841,000	13,220,000	12,156,000	11,143,000	9,180,000	8,397,000
Revenue passenger miles (000)	10,737,000	8,594,000	9,675,000	9,231,000	7,641,000	4,760,000	3,847,000	3,364,000	2,584,000	2,304,000
Available seat miles (000)	18,268,000	17,113,000	17,773,000	16,585,000	15,119,000	10,185,000	7,479,000	6,010,000	5,152,000	4,611,000
Passenger load factor	58.8%	50.2%	54.4%	55.7%	50.5%	46.7%	51.4%	56.0%	50.2%	50.0%
Cargo ton miles (000)	117,000	95,000	80,000	65,000	51,000	37,000	32,000	28,000	23,000	22,000
Revenue plane miles (000)	172,000	162,000	168,000	156,000	145,000	102,000	81,000	71,000	62,000	58,000

*Includes results of Republic Airlines West, Inc., a consolidated subsidiary, from October 1980 through December 1985. During December 1985, the subsidiary was dissolved and remaining net assets were transferred to the Company.

Management's discussion and analysis

Operating revenues

Total operating revenues increased 12.1 percent in 1985 to $1.7 billion following a 2.4 percent increase in 1984, primarily from substantial growth in passenger revenues. Representing more than 92 percent of total operating revenues, passenger revenues increased 12.9 percent in 1985 due primarily to the 25.9 percent growth in scheduled revenue passenger miles. The impact of this substantial traffic growth was partially diminished by a 10.3 percent decline in average revenue per scheduled passenger mile (yield) which decreased from 16.63 cents in 1984 to 14.92 cents in 1985.

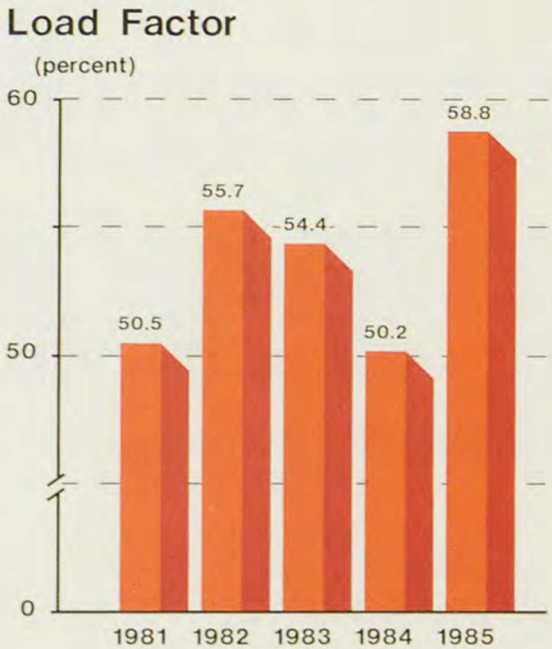
The increase in scheduled revenue passenger miles in 1985 exceeded the increase in capacity resulting in an 8.6 point increase in passenger load factor to 58.8 percent. The major route restructuring implemented during 1985 along with a strong economy, discount fares which stimulated leisure travel, and strong support of Republic Express service contributed to the growth in traffic. Discount fares such as the Ultimate Super Saver Fare were introduced to stimulate leisure travel on a capacity controlled basis. This resulted in an increase in revenue per available seat mile even though yields declined. Increased competition from low fare airlines has continued to exert pressure on fares and will continue to impact yield in the future.

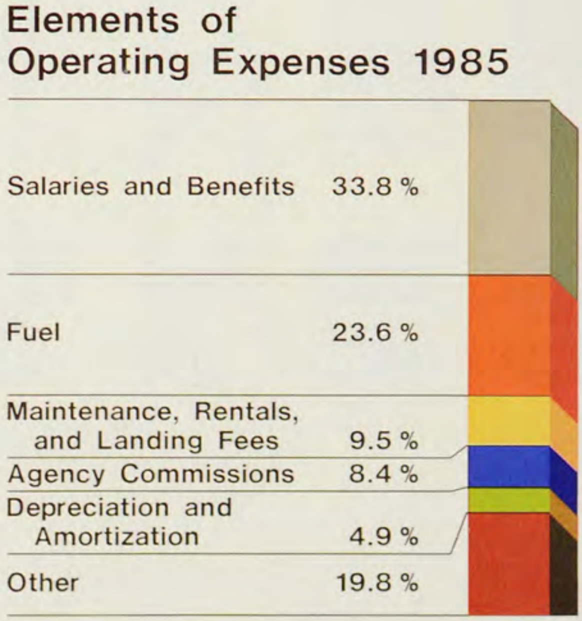
In 1984, passenger revenue increased 2 percent over 1983 because of the substantially higher yield of 16.63 cents compared with 14.41 cents in 1983. Scheduled revenue passenger miles dropped 11.7 percent in 1984 following inflated traffic levels of 1983 which were stimulated by extensive fare wars and special promotions.

Cargo revenues increased 8.4 percent in 1985. On January 1, 1985, the Postal Service implemented a system of competitive bids which determines carriage of mail by all airlines. The Company aggressively pursued these contracts and as a result, mail ton miles increased 116.2 percent in 1985 while mail revenue rose 79.5 percent to $37.2 million from $20.7 million in 1984. Other cargo revenues dropped 17.6 percent due to lower freight yields caused by the discounting of freight rates and also a 23.1 percent decline in freight ton miles.

Operating expenses

Operating expenses increased 8.3 percent in 1985 following a decrease of 6.2 percent in 1984. The largest component, salaries and employee benefits, which represented 33.8 percent of total operating expenses in 1985, increased 4.7 percent over the previous year. A wage freeze and





15 percent pay reduction instituted in September 1983, utilization of part-time employees, and lower starting rates for new employees which were effective for all employee groups, enabled the Company to hold salaries exclusive of benefits at $410.8 million which is an increase of less than 1 percent from 1984. This was accomplished even though the average number of employees increased 3.5 percent in 1985. Employee benefits increased 21.5 percent to $120.1 million in 1985. Amortization of the value of securities and the preferred stock profit-sharing dividend for 1985, both granted to employees in exchange for pay concessions, added $16.5 million to employee benefits compared with $6 million in 1984.

In 1984, salaries and benefits decreased 12.8 percent from 1983 as a result of the impact of employee concessions and a change in actuarial assumptions for all defined benefit pension plans which reduced pension expense by $8.7 million.

Aircraft fuel expense increased 2.9 percent over 1984. Fuel prices continued to drop during 1985 resulting in a 4.5 percent drop in average price per gallon to 80.6 cents in 1985 compared with 84.4 cents in 1984. This followed a drop of 4.4 percent in 1984 from 88.3 cents in 1983. Expansion of service and addition of 11 aircraft in 1985 resulted in an increase of 5.8 percent in revenue plane miles which accounted for the overall increase in fuel expense. In 1984, revenue plane miles decreased 3.3 percent, which contributed to the 8.1 percent decrease in fuel expense. Expenditures for maintenance materials and repairs increased 19.5 percent in 1985, largely attributable to interior modifications and exterior painting of aircraft. First Class seating now is offered in all Boeing 727 and DC-9 aircraft. Agency commissions increased 26.6 percent as a result of the 12.9 percent increase in passenger revenue and because 78 percent of sales were generated by travel agents compared with 72.5 percent in 1984. In order to meet the competition, the Company was forced to expand override commission programs throughout the United States.

The expansion of operations through development of major hubs at Minneapolis/St. Paul, Detroit and Memphis and related marketing activities had significant impact on other operating expenses which increased 15.2 percent. Of this $41 million increase, $17.1 million reflects an increase in co-host fees for computer reservations systems which increased because of the higher volume of bookings and significant rate increases. Outside services purchased increased $8.8 million in conjunction with hub development.

In 1984, other operating expenses increased 2.6 percent. The increase in selling and marketing expense, including co-host fees for computer reservations systems of $5.1 million and $6.4 million in costs related to route realignment (including addition of 8 destinations and suspension of operations at 23 points), were the factors causing the increase over 1983. Expenditures for advertising were reduced $7.3 million, reflecting elimination of numerous promotions initiated in 1983 and the adoption of more efficient direct marketing techniques.

Operating profit

The 1985 operating profit of $166.3 million was 66.3 percent over 1984. The operating margin of 9.6 percent increased from 6.5 percent in 1984, and was favorably impacted by improvement in load factor of 8.6 points. The $131 million increase in operating profit in 1984 was the result of substantially higher yields and the 6.2 percent reduction in operating expenses.

Other expenses (income)

Interest expense decreased 7.1 percent to $90.1 million in 1985 as the average prime rate and outstanding long-term debt and obligations under capital leases declined.

Gains from disposition of property, equipment and lease rights totaled $21.4 million in 1985 compared with $17.3 million in 1984 and $923,000 in 1983. In 1983, $13 million was realized from the sale of tax benefits which is not expected to occur in the future.

Interest income from temporary investments of excess cash generated $17.9 million in 1985 compared with $6.9 million in 1984 and $2.5 million in 1983.

Income taxes

The Company recorded income tax expense of $50.3 million in 1985 and $15.8 million in 1984. Utilization of tax loss carryforwards of $45.6 million in 1985 and $15.8 million in 1984 was recorded as an extraordinary

Management's discussion and analysis (continued)

gain in the financial statements. In both years, payment of virtually all of the provision for federal income taxes was deferred due to timing differences between financial and tax reporting. For additional analysis of income tax expense and utilization of tax loss carryforwards, see Note E to the consolidated financial statements, page 29.

Gain on pension plan termination

As part of the Company agreement with the pilots' union, the pilots' defined benefit pension plan was terminated in 1985 and replaced with a defined contribution plan. The Company had received waivers of the 1981, 1982, and 1983 funding obligations for this plan. Since assets of the plan exceeded the fully vested benefits, the obligation to fund the waived amounts and other accrued pension liabilities for the plan were eliminated resulting in the recording of a $62.2 million extraordinary gain in 1985.

Net earnings

Net earnings of $177 million ($4.74 per primary share) were achieved in 1985 compared with $29.5 million (76 cents per share) in 1984 and a net loss of $111 million ($4.28 loss per share) in 1983. The 1985 and 1984 earnings include extraordinary gains of $107.8 million ($2.94 per share) and $15.8 million (46 cents per share), respectively.

Inflation and changing prices

For information concerning the effects of inflation and changing prices on the Company's operations, see "Supplemental stockholder information," pages 34 and 35.

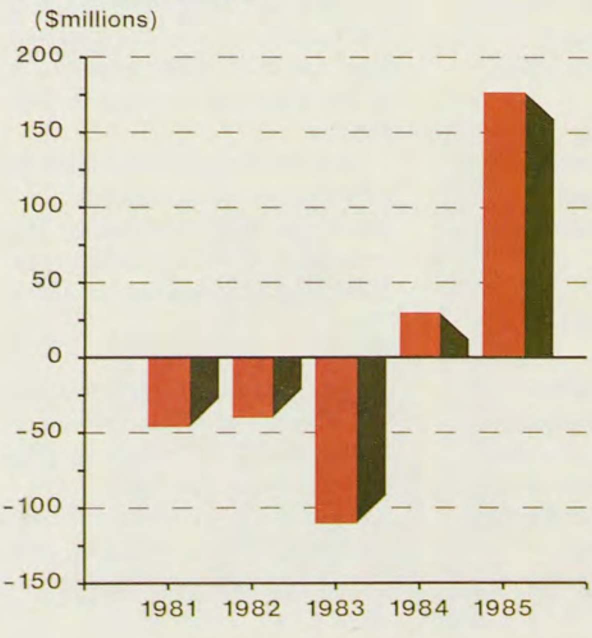
Stockholders' equity

Total stockholders' equity increased $187.4 million in 1985 and $31 million in 1984 primarily as a result of improved earnings which generated increases in retained earnings of $173.3 million in 1985 and $25 million in 1984. The remaining increase is attributable to the exercise of stock options and issuance of securities to the Employee Stock Ownership Plans in connection with the agreements with employees for reductions in salaries and wages.

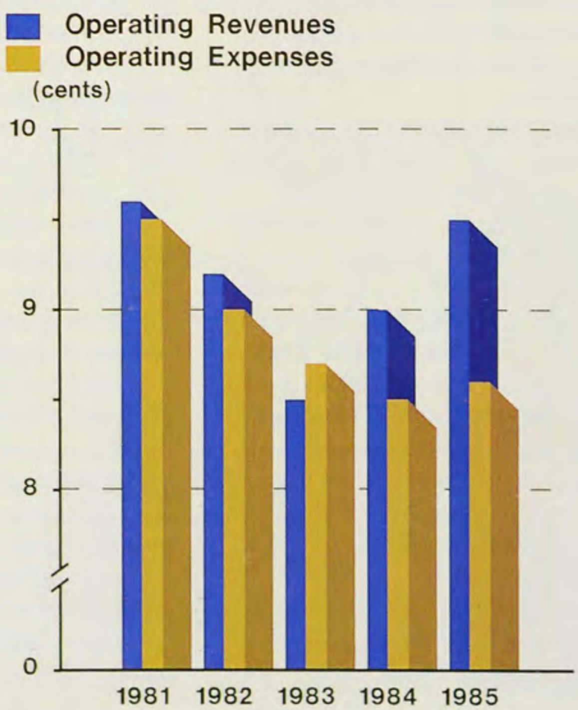
Cash flow, liquidity and capital resources

The Company's liquidity position has improved significantly since the end of 1983. Cash and

Net Earnings



Operating Revenues and Expenses Per Available Seat Mile



short-term cash investments were $59.8 million at December 31, 1983, $123.1 million at December 31, 1984, and $300.1 million at December 31, 1985. Cash used in operations amounted to $73.8 million in 1983, while cash provided from operations was $132.3 million in 1984 and $258.7 million in 1985.

During December 1985, all remaining Republic Airlines West, Inc., $100 par value Cumulative Preferred Stock was purchased by the Company. Following this purchase, Republic Airlines West, Inc., was dissolved, with remaining net assets transferred to the Company.

Since 1982, the Company has supplemented its working capital and conserved cash primarily by the means discussed below:

1. Reduction of Wages

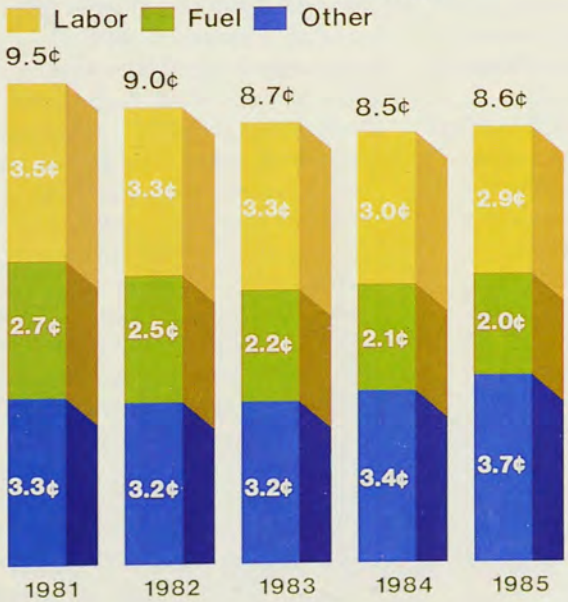
In September 1983, all employees, including management, accepted a wage freeze and 15 percent wage reduction. During 1984, these agreements were extended for all employee groups with contract amendable dates in late 1986 and early 1987 and contained additional productivity provisions.

In exchange for the concessions, the Company agreed to issue 5,529,195 shares of common stock and provide a profit-sharing arrangement in the form of $72.3 million face amount of a new class of participating, non-cumulative, non-voting junior preferred stock with 2,170,000 callable warrant rights to purchase common stock at $10 per share. The preferred stock allows the employees to receive dividends, based on a per share dividend rate of 1/10,000 of 15 percent of the Company's profit (operating profit, less interest expense and income taxes to be paid) in excess of $20 million. The profit-sharing distribution cannot exceed $10.8 million in any one year. The amount to be paid in 1986 for the year 1985 will be approximately $6.8 million. In addition, the Company has agreed not to pay dividends on common stock through December 31, 1986, and to fill one position on the Board of Directors with an individual of national prominence to be chosen by agreement of all the Company's union groups and reasonably acceptable to the Company's Board of Directors. As of the date of this report, the Board member has not yet been selected by the union groups.

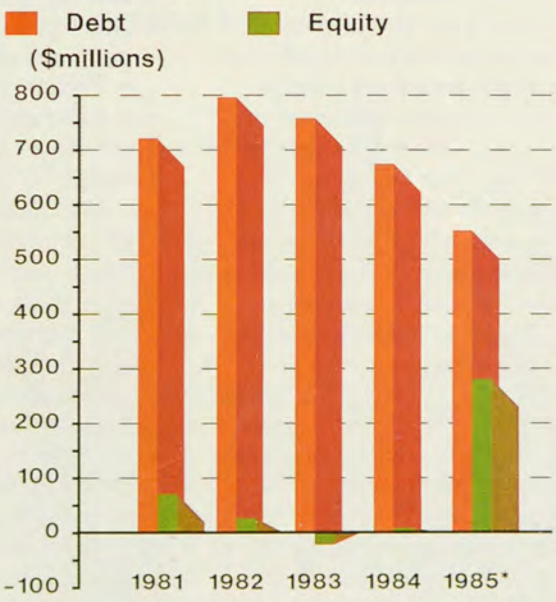
2. Pension Contribution Waivers

Pursuant to waivers granted by the Internal Revenue Service, the Company deferred pension funding payments totaling $47.1 million which were due to be paid to pension plans for its employees for

Operating Expenses Per Available Seat Mile



Capitalization



*Includes conversion into common stock of convertible subordinated debentures called for redemption in 1986 the years 1981 and 1982. Payment of the 1981 and 1982 deferred amounts plus interest is being funded over a 15-year period, commencing in 1983.

As part of the labor negotiations in 1984, the Company and pilots' union agreed that the Company would terminate the pilots' defined benefit pension plan and establish defined contribution retirement and health benefit plans. The Company also received a waiver of the 1983 funding obligation of $21.8 million for this pilots' pension plan. The Company's obligation to fund its accrued pension liability for the pilots' plan has been eliminated because the assets of the plan exceeded the fully vested benefits. The elimination of these accrued pension liabilities resulted in recording an extraordinary gain of $62.2 million in 1985.

3. Sale of Tax Benefits, Aircraft and Other Property

During 1983, the Company received net proceeds of $13 million from the sale of tax benefits related to the acquisition of new flight equipment which were applied to the purchase of new aircraft. Due to changes in the tax laws, the Company is no longer able to sell tax benefits for new property which it acquires. During the years 1983 through 1985, the Company received $56.6 million from the disposition of aircraft, other property, and lease rights. Of these net proceeds, $18.9 million was used to repay indebtedness, and the balance was used for working capital.

4. Issuance of Securities

In June 1983, through a unit offering of 7,480,000 shares of common stock and 3,740,000 warrants to purchase common stock, the Company received net proceeds of $58.3 million which were used for working capital.

The Company is highly leveraged. At December 31, 1985, the Company had long-term debt and capital lease obligations, including current maturities, of $726.7 million. Interest rates float with prime on 27.7 percent of this debt.

At December 31, 1985, the Company had approximately $185.9 million outstanding under its Bank Credit Agreement. The agreement requires the Company to meet certain financial covenants including debt-to-equity ratios and net-worth requirements, a cash and short-term cash investments minimum, limitations on capital expenditures and additional debt, and sets restrictions on the payment of common stock dividends. The Company expects to remain in compliance with the covenants contained in the Bank Credit Agreement over the remaining term of the loan based on assumed operating results.

In February 1985, the Company sold $150 million of Senior Secured Trust Notes ($75 million due February 1, 1990, at 14.625 percent and $75 million due February 1, 1993, at 15.125 percent). The proceeds were used to prepay $110 million under the Bank Credit Agreement with the net balance of $35 million, after discounts and expenses of $5 million, used to increase working capital.

During 1985 the Company leased three used Boeing 727-200 aircraft and three used DC-9-30 aircraft under operating leases which extend for periods ranging up to five years. The Company also purchased a used DC-9-30 aircraft, two DC-9-30 aircraft previously under operating leases and one DC-9-30 under a capital lease. These four aircraft were financed primarily through an $18.7 million promissory note. One used DC-9-10 aircraft was purchased in December 1985. One MD-80 aircraft which was previously leased was returned to the Company for scheduled operations.

During the third quarter of 1985, the Company signed a purchase agreement with The Boeing Company for the purchase of six 190-seat 757-2S7 aircraft. Three were delivered in December 1985 with the remaining three scheduled for delivery in May 1986. The total cost of the six aircraft, including Rolls Royce engines, spare engines, and parts is approximately $231 million. The Company arranged operating lease financing on the first three aircraft. Financing for the remaining aircraft has not been determined. The Company also has options to acquire up to six additional Boeing 757-2S7 aircraft.

The Company has major terminal expansion and improvement activities taking place at each of its three hubs. Besides significantly expanding the number of gates, new Executive Suites and baggage handling facilities will be included. In Detroit, planned improvements include installation of an underground fueling system, an addition to the terminal for baggage handling, acquisition of additional gates, construction of a new flight kitchen, and installation of moving sidewalks. The Detroit airport improvements are being financed with proceeds of $90.5 million of Special Airport Facilities Revenue Bonds issued by a municipality. The Company has guaranteed the bond payments. Projected costs of the Memphis terminal expansion and improvements, including baggage handling facilities, are estimated at $21.5 million and are being financed primarily through general obligation bonds issued by the airport authority. The Company has entered into revised lease agreements at these locations which provide for increased rent as a result of these improvements. In Minneapolis/St. Paul, terminal additions and improvements are anticipated to be approximately $10 million, of which $3 million is to be paid by the airport authority, with the remaining portion funded internally.

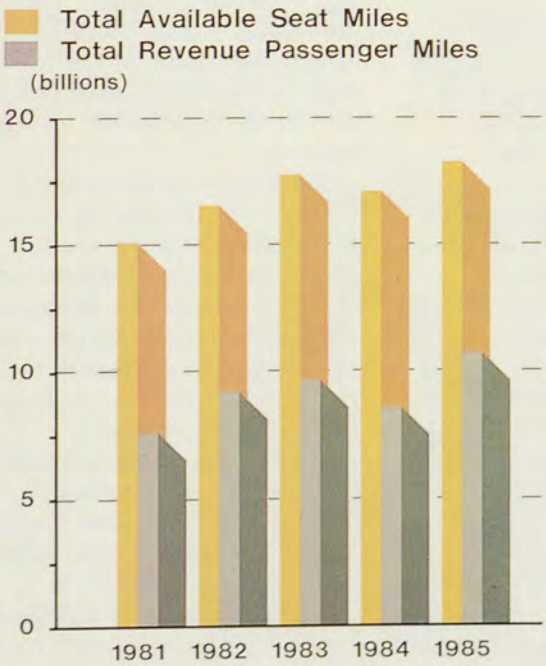
In addition, reservations services have been consolidated to improve efficiency and reduce line costs. A new 54,000 square-foot facility in Livonia, Michigan, a Detroit suburb, was constructed. The facility began operation during the third quarter of 1985 and now answers more than 50 percent of all reservations calls.

The timing and source of future capital needs cannot be estimated and will largely depend on new and replacement aircraft requirements. The Company periodically acquires computer equipment, ground property and equipment, and leasehold improvements. Future capital expenditures and debt to be incurred are subject to restrictions contained in the Bank Credit Agreement.

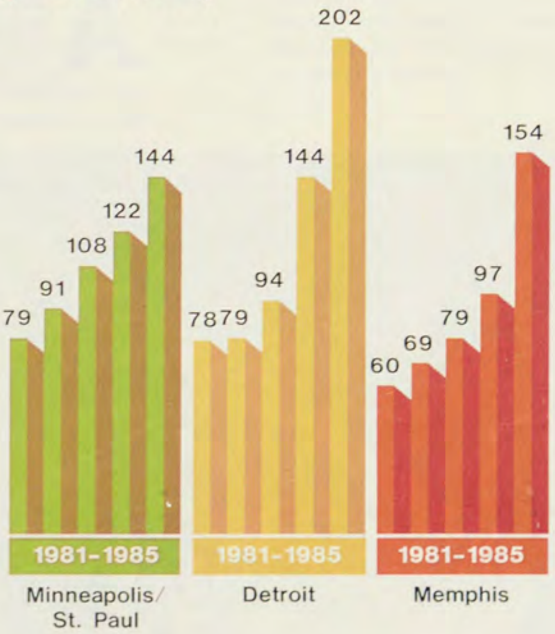
In January 1986, the Company called for redemption all of the 10-1/8% Convertible Senior Subordinated Debentures and the 13% Convertible Subordinated Debentures. The 10-1/8% Debentures were converted into 7,442,400 shares of common stock, and the 13% Debentures are expected to be converted into 1,043,919 shares (see Note M to the consolidated financial statements on pages 32 and 33 of this report).

On January 23, 1986, the Company entered into a merger agreement with NWA Inc. (NWA). NWA is the parent company of Northwest Airlines, Inc., a certified air carrier. Under this agreement the Company will become a subsidiary of NWA. On the effective date of the merger, NWA will acquire all of the outstanding shares of the Company's common stock at a price of $17 per share. The merger is subject to several conditions including approval by the Company's stockholders and certain governmental authorities. For additional information on the proposed merger, see Note M to the consolidated financial statements on pages 32 and 33.

Capacity and Traffic



Daily Departures (December)



For Republic Airlines, 1985 was The Year of the Business Traveler. Attention was focused on how to attract and retain frequent business travelers whose loyalty is essential to a successful airline. To a large degree, Republic's traffic and financial records established in 1985 are the results of the airline's attractiveness to its business clients.

During 1985, Republic took several major steps to enhance its standing among the important business traveler market. Those steps paid off with traffic growth of more than 30 percent for eight consecutive months – May through December – and this pace has extended into January and February 1986. The ability to increase traffic significantly, while establishing only minor increases in seat capacity, demonstrates the effectiveness of this effort.

Route realignment

A key element in coaxing business flyers to Republic was a far-reaching route realignment finalized in April, then refined throughout the remainder of the year.

Strategy called for concentration of flights at Republic's three primary airports – Detroit, Michigan; Minneapolis/St. Paul, Minnesota; and Memphis, Tennessee. Resources were redeployed, and on April 28, 56 daily departures were added in Memphis, 22 at Minneapolis/St. Paul, and 19 at Detroit. This brought Republic's service level in these cities to 153, 152, and 178 daily flights respectively. On the same day, Republic initiated flights at eight new cities in one of the largest service expansions in commercial aviation history.

During 1985, flights were begun at Pittsburgh and Erie in Pennsylvania; Albany, Syracuse, White Plains, and John F. Kennedy International Airport in New York; Little Rock, Arkansas; Louisville, Kentucky; Shreveport, Louisiana; Appleton, Wisconsin; Akron/Canton, Ohio; and Intercontinental Airport, Houston, Texas.

On December 15, Republic began flights from Memphis to Puerto Vallarta, Mexico, and announced that service between Memphis and Cancun, Mexico, would start in January 1986. In addition, Dayton, Ohio, and Cedar Rapids, Iowa, were scheduled to join the route system and this service was inaugurated in February 1986.

By concentrating flights at three key traffic centers, Republic was able to generate 97 percent of its available seat miles on flights to and from these "hubs." This offers passengers a wide variety of connecting flights at the hubs and ensures passengers single-carrier service for their entire traveling itinerary.

The success of the route realignment became evident in May when passenger traffic increased nearly 31 percent with only a 7 percent rise in capacity. The traffic growth continued at a record pace throughout the remainder of the year with growth exceeding 40 percent year-over-year in June, October, November, and December. In October and November, Republic posted the highest load factor among the major airlines.

A change in the Postal Service's method of awarding mail contracts, combined with the route restructuring, had an impressive effect on cargo sales and service. Republic's cargo ton miles increased 23 percent to 116.9 million in 1985. Particularly remarkable growth was registered in mail revenues, closing the year at $37.2 million, up from $20.7 million in 1984. Each day in 1985, Republic averaged more than 180 tons of mail, a yearly total of 132.6 million pounds, almost twice the 1984 level.

Republic Express

An important element in the record passenger traffic was the initiation of Republic Express service to smaller communities within a 350-mile radius of the three hubs. Republic Express flights are provided by regional airlines under long-term marketing contracts with Republic. Republic Express flights are timed to reach the hubs so passengers can make easy, convenient connections to Republic flights.

Republic Express service made its debut in late April with flights to Detroit from 16 communities in Michigan and Ohio. The service was provided by Simmons Airlines. On June 1, Express Airlines I, also operating as Republic Express, began service at Memphis, and by year end the airline linked Memphis with 12 cities in the southeastern United States. Republic Express began flights from Minneapolis/St. Paul in December, with nonstops to Aberdeen and Watertown, South Dakota. By mid-1986, Republic Express flights will be available to nine other communities in the Midwest.

The close relationship between Republic and Republic Express is evident in the Republic Express name and in the marketing services the airlines offer jointly. Republic Express flights use Republic gates and are listed in computer reservations systems under Republic's name. Advance seat selection is offered, and Republic Express provides the full fare structure of Republic.

In addition to sharing Republic's name and identity, Republic Express partners adopt the high standards of performance and

McDonnell Douglas DC-9s are the backbone of Republic's fleet of 168 jetliners. Republic operates 134 of the versatile twin-jets on a route system spanning 34 states, Canada, Mexico and the Cayman Islands in the Caribbean.

professionalism that Republic demands of itself.

Facilities expansion

Coupled with the route restructuring, Republic embarked on major construction programs in 1985 to improve its passenger service facilities. Emphasis was placed on enlarging Republic Executive Suites at key airports with new suites opening in 1985 at Detroit, Minneapolis/St. Paul, and Memphis; another suite opened in early 1986 at Chicago O'Hare. The Executive Suites offer business travelers an opportunity to escape the passenger concourse and turn waiting time into productive time. Work modules, phones, conference rooms, cash bar, newspapers, magazines, television, and other amenities are available. Republic charges only $75 for first-year Executive Suite membership and $50 annually thereafter.

Passenger facilities at hub airports also were expanded to better serve Republic's increasing number of business clients. Passenger gates at Detroit were increased from nine to 34; Memphis from 17 to 42; and Minneapolis/St. Paul from 11 to 19. Additional improvements were made to baggage handling areas. Ramp control towers were constructed to better orchestrate the ground movement of aircraft and support equipment.

In Detroit, Wayne County issued $90.5 million in bonds to support Republic construction programs at Detroit Metropolitan Airport. On the agenda are additional gate space, moving sidewalks, an enlarged baggage building, an underground aircraft fueling system, and a flight kitchen – as well as other remodeling and expansion programs.

Training

Just as rapid expansion forced enlargement of passenger facilities, the new-found business success also demanded professional training programs for new and seasoned employees to ensure service standards were not compromised.

During the year Republic hired and trained more than

Agents at Republic's new Livonia, Michigan, reservations center respond to more than 40,000 telephone inquiries from Republic passengers each day.

1,000 reservations agents to handle a growing passenger call volume. Most of the reservationists are employed at a new, state-of-the-art reservations center which opened August 16 in Livonia, Michigan, a Detroit suburb. The center employs nearly 800 agents who handle more than 40,000 phone inquiries each day. Many of the Livonia agents were hired and trained through a unique job program for the unemployed and disadvantaged offered in conjunction with the Wayne County Private Industry Corp. A mixture of federal, state, and local funds was used to screen, select, hire, and train workers for jobs at Republic's Livonia reservations facility.

The expanded route system called for additional training of passenger service personnel. Nearly 1,600 station agents and passenger service agents completed coursework in 1985 during 115 training sessions varying from one to three weeks. During one week alone, customer service personnel conducted 14 classes simultaneously. In addition to training its own employees, Republic also assumed responsibility for training customer-contact personnel of Republic Express. Republic's computer-based instruction programs were expanded significantly to include additional training modules in reservations, ticketing, seat selection procedures, and aircraft weight and balance calculations. Relying heavily on Republic-produced videotapes, a series of training bulletins, and on-site inspections, the airline undertook a broad ramp awareness program. Particular attention was paid to ground safety, ramp security, and foreign object damage to jet engines. A signalman certification program also was developed for all Republic workers responsible for the ground guidance of taxiing aircraft.

During 1985, Republic recruited and trained 698 flight attendants at its Atlanta Training Center. For each flight attendant position, 50 applicants are considered – indicative of the high standards Republic demands. The intensive month-long flight attendant school focuses on awareness of customer needs, passenger service techniques, emergency medical procedures, first-aid practices, and federal rules governing air transportation.

The Atlanta training facility was a busy place in 1985. In addition to flight attendant training, the bulk of Republic pilot training is conducted in Atlanta, including

Efficient, coordinated movement of aircraft and ground support equipment results from the efforts of Republic personnel staffing new ramp control towers at each of the airline's main traffic centers.

that for 337 newly hired pilots. More than 1,200 other pilots received simulator instruction in 1985, with 217 receiving initial Boeing 727 training; 53 in their initial MD-80 program; 416 received initial DC-9 instruction, and 80 were qualified for Convair 580s. Refresher and requalification training saw another 400 pilots pass through Republic's complement of four flight simulators. These programs are in addition to recurrent ground school training, required annually of all pilots and first officers, and the proficiency checks provided captains every six months and given first officers each year.

In addition to training its own cockpit crews, Republic earned more than $3.3 million in 1985 in contract training for other airlines. FAA inspectors also used Republic simulators for their annual training requirements.

Republic uses the latest in audiovisual technology to standardize training and reduce related costs for personnel in the air as well as on the ground. As an example, the airline's audiovisual support included a video show outlining the pre-flight responsibilities of a Boeing 727 flight engineer. This eliminated the costly expense of removing a Boeing 727 from service for training and also eliminated the need for classes to make a field inspection of the aircraft at this point in their training program.

Republic's field sales force participated in quarterly two-day training seminars to enhance their professionalism and job knowledge. Topics included negotiation skills, counselor selling, and time and territory management. Emphasis was given to expanding the sales staff's knowledge of the eight computer reservations systems that list Republic flights. Republic's automated marketing personnel developed a detailed manual for sales managers, outlining the operations and capabilities of various computer reservations systems. This enables the sales staff to discuss those systems effectively with their travel agent partners.

Flight crew skills are honed through frequent visits to one of Republic's four flight simulators where instructors can safely present flight conditions to crew members and gauge the speed and effectiveness of their responses.

Frequent Flyer Perks

A significant element in the drive to secure business travelers is Republic's liberal Frequent Flyer program which rewards members for repeated use of Republic flights. The program's success is evidenced by the fact that more than one million business travelers are Republic Frequent Flyers. Republic gives Frequent Flyers a free roundtrip ticket for every 20,000 miles credited to their account. As 1985 ended, Republic announced a major Frequent Flyer improvement– the addition of Radisson Hotels and Western Airlines. Pan American World Airways, along with Hertz and

National Car Rental, remained members of the program. Thus, Republic Frequent Flyers now are able to earn free travel to Hawaii, Europe, and other international destinations by traveling on Republic. Frequent Flyers also earn mileage awards for using the services of Radisson Hotels, Hertz, and National and, in turn, the three participants offer discounts and free services to Republic Frequent Flyers who earn free tickets.

During 1985, Republic began an intensive study of its front cabin service and decided to replace Business First Class with First Class – a move that made its debut in February 1986. Menus were studied, modified, and upgraded; wines sniffed, swirled, tasted, and selected; other amenities evaluated, tested, and chosen; and employees informed, trained, and motivated to provide the highest service standards. The result is a First Class front cabin that is available to Frequent Flyers at the same rate as the Business First Class service it replaced. Other First Class passengers pay prevailing industry rates, generally 30 percent more than coach fares. The marketing strategy, again, is to make Republic attractive to its primary customers – frequent business travelers.

Both the Frequent Flyer program and front cabin service were key ingredients in Republic's successful "Perks" advertising campaign which was expanded during 1985. The "Perks" approach effectively targets business travelers with the theme, "Perks: You've Earned Them."

While most attention was paid to developing the business travel market, Republic also continued efforts to capture its share of vacation and leisure travelers. These passengers are primarily motivated by price considerations and thus highlight the importance of Republic's yield management team. The airline was determined to remain competitive with low-cost carriers by offering the same fares in an effort to attract vacation travelers. As a result, Republic refined its seat inventory management and pricing functions to make certain the proper mix of discount and full-fare seats were offered on all flights, which maximized total revenue while providing a full range of fares attractive to all segments of the traveling public. During 1985, Republic became an industry leader in pioneering pricing initiatives that offered excellent discounts to vacation and leisure travelers, stimulating discretionary travel and contributing to profitability.

Travel agents

While Republic marketed itself directly to the consumer in 1985, the airline also took major steps to increase its visibility with the nation's travel agencies. More than 80 percent of Republic tickets are written by travel agents who are a key element in Republic's financial resurgence. To supplement the airline's field sales force, Republic instituted a telemarketing department in 1985 so travel agencies and corporate travel departments can receive immediate assistance on the phone from experienced sales personnel. The airline also reorganized its sales staff into three regions

(continued on page 20)

Republic Express

Republic Express service, provided by Republic's regional airline partners, links Republic hubs at Detroit, Minneapolis/St. Paul and Memphis with smaller cities near these main traffic centers. Under a joint marketing agreement, the regional carriers coordinate their flight schedules to the hubs to ensure quick, convenient connections to Republic flights.

Minneapolis/St. Paul

Detroit

Memphis

Republic Airlines

System Route Map – March 2, 1986

(continued from page 17)
headquartered at the airline's hubs, Detroit, Minneapolis/St. Paul, and Memphis. At the General Office, an area marketing staff was formed to provide the sales regions with timely, responsive support from senior marketing officials.

Republic formed a Travel Agency Advisory Board during 1985. The membership consists of key travel agency owners and managers plus Republic's top marketing staff. The group meets quarterly to exchange information, share problems, and devise solutions. Among the results of the Board's discussions was a public reaffirmation by the airline of its unqualified support for the travel agency ticket distribution system and Republic's opposition to "corporate self-dealing" whereby a company establishes a travel agency primarily for its own benefit.

Republic also played an important role in the 1985 annual meeting of the American Society of Travel Agents in Rome, including co-sponsorship of closing-day deliberations and ceremonies.

Fleet improvements

Because of Republic's impressive traffic gains during the year, the airline ordered six Boeing 757 jetliners to meet increased demand. Three of the fuel efficient, 190-passenger aircraft entered service in December and the remaining three will join Republic by mid-1986. Republic has options for future delivery of six more Boeing 757s.

The Boeing 757s are used on long-haul flights, principally from Detroit to the West Coast. Load factors on these flights have been excellent while fuel consumption and noise generation have been remarkably low.

Republic added eight other aircraft to its fleet in 1985 – three Boeing 727-200s and five McDonnell Douglas DC-9s.

In addition to the fleet expansion, Republic's maintenance and engineering division undertook a number of major modifications to Republic aircraft to improve passenger comfort. Republic's DC-9-10s were reconfigured to include a First Class forward cabin. This standardized Republic's jet fleet, which allowed First Class service to be offered on all legs of a passenger's itinerary. In addition, a project was begun to install new trimline seats in all Republic DC-9-30 aircraft. Seating capacity will increase from 95 to 100 and at the same time passengers will receive extra leg room, thanks to the latest technology in passenger seating comfort.

Republic's maintenance and engineering division helped

Republic's Fleet

		Number of Aircraft				
Aircraft	No. of Seats	Owned	Leased	Total	On Order	Options
B-757-2S7	190		3	3	3	6
B-727-200	143	15	3	18		
MD-80	143	7	1	8		
DC-9-50	122	16	12	28		
DC-9-30*	95	56	8	64		
DC-9-10	78	31	3	34		
Convair 580	48	13		13		
Total		138	30	168	3	6

**DC-9-30 aircraft will have 100 seats effective June 15, 1986.*

develop several advances in maintenance technology which will become standards in the airline industry in the future. For example, Republic was the first airline to use portable boroscopes for detailed inspections of engine combustion chambers. The new equipment and procedures allow careful inspections while the engine is still mounted on the aircraft. This reduces the need to remove and dismantle engine components. Republic also installed a computerized machining center at its Atlanta maintenance base which will save more than $250,000 annually in metal fabrication expenses. This center is used to create engine gearboxes, seat track channeling, bearing liners, and other components. Republic was the airline that pioneered bead-blasting for stripping paint from aircraft exteriors. The stripping process, using recyclable plastic beads, is so precise it allows the removal of a single coat of paint without roughing up the fuselage. An aircraft can be stripped and repainted every five days instead of every seven days.

Maintenance and engineering personnel also were eager to share their cost-saving ideas through the Company's suggestion program. A team of three mechanics developed a probe to be installed in DC-9 auxiliary power units that is credited with reducing carbon seal failures on an average of 18 power units annually. Another mechanic initiated a program to develop in-house a component of the DC-9 temperature control system, while a worker in Republic's sheet metal shop designed, manufactured, and installed the lower panel of cockpit doors, saving expensive replacement purchases from an outside supplier. Other ideas made similar contributions.

In late 1985, the Federal Aviation Administration released results of an intensive study of maintenance programs at 300 airlines and found Republic with the lowest percentage of unsatisfactory maintenance inspections among the major airlines – a credit to the pride and professionalism of the 2,900 men and women of the maintenance and engineering division.

Summary

A firm focus on frequent business travelers was Republic's success formula in 1985. An effective route system coupled with professional, caring employees who provide quality service consistently, attracted new passengers and retained the loyalty of Republic's Frequent Flyers.

Travelers can work or relax away from the hubbub of airport passenger concourses by becoming Republic Executive Suite members. A variety of amenities cater to the needs of frequent business passengers.

Consolidated balance sheets

(in thousands)

ASSETS	December 31 1985	December 31 1984
CURRENT ASSETS		
Cash and short-term cash investments	**$ 300,085**	$ 123,143
Accounts receivable–less allowances	**158,108**	109,193
Parts and supplies–less reserves	**35,657**	38,898
Prepaid expenses and other	**34,435**	31,562
	528,285	302,796
PROPERTY AND EQUIPMENT OWNED		
Flight equipment	**924,199**	891,776
Ground property and equipment	**130,067**	113,312
	1,054,266	1,005,088
Less accumulated depreciation	**419,797**	361,154
	634,469	643,934
PROPERTY AND EQUIPMENT UNDER CAPITAL LEASES		
Flight equipment	**153,828**	157,145
Ground property and equipment	**12,468**	16,281
	166,296	173,426
Less accumulated amortization	**62,433**	55,682
	103,863	117,744
DEFERRED CHARGES AND OTHER ASSETS	**19,680**	20,435
	$1,286,297	$1,084,909

LIABILITIES AND STOCKHOLDERS' EQUITY

	December 31	
	1985	1984
CURRENT LIABILITIES		
Current maturities of long-term debt	**$ 83,802**	$ 59,696
Current obligations under capital leases	**9,207**	8,712
Air traffic liability	**128,647**	84,661
Accounts payable	**76,776**	43,776
Accrued compensation and vacation benefits	**58,230**	46,872
Accrued interest	**18,506**	11,214
Accrued pension liability	**7,067**	22,464
Other accrued expenses	**33,466**	26,751
	415,701	304,146
LONG-TERM OBLIGATIONS		
Long-term debt–less current maturities	**509,434**	538,282
Noncurrent obligations under capital leases	**124,225**	136,933
Long-term pension liability and other	**40,856**	68,908
	674,515	744,123
COMMITMENTS AND CONTINGENCIES (Notes B, D, I and L)		
REDEEMABLE PREFERRED STOCK OF SUBSIDIARY	**–**	28,000
STOCKHOLDERS' EQUITY		
Preferred stock–authorized 25,000,000 shares of $.01 par value	**–**	–
Common stock–authorized 60,000,000 shares of $.20 par value; outstanding–33,567,241 shares in 1985 and 30,639,390 shares in 1984	**6,713**	6,128
Additional paid-in capital	**129,097**	114,664
Retained earnings (deficit)	**55,076**	(118,176)
Employee stock to be issued	**15,699**	26,571
Unearned compensation for stock to be issued	**(10,504)**	(20,547)
	196,081	8,640
	$1,286,297	$1,084,909

The accompanying notes are an integral part of these statements.

Consolidated statements of operations

(in thousands, except per share amounts)

	Year Ended December 31		
	1985	**1984**	**1983**
OPERATING REVENUES			
Passenger	**$1,598,237**	$1,415,583	$1,388,285
Cargo	**83,832**	77,318	76,626
Other	**52,328**	54,331	46,583
	1,734,397	1,547,232	1,511,494
OPERATING EXPENSES			
Salaries and benefits	**530,911**	506,905	581,496
Aircraft fuel	**369,912**	359,417	390,937
Agency commissions	**132,180**	104,420	102,258
Rentals and landing fees	**79,084**	75,290	76,863
Maintenance materials and repairs	**69,485**	58,167	58,111
Depreciation and amortization	**76,482**	74,008	70,625
Other	**310,013**	269,023	262,221
	1,568,067	1,447,230	1,542,511
Operating profit (loss)	**166,330**	100,002	(31,017)
OTHER EXPENSES (INCOME)			
Interest expense	**90,092**	97,000	97,852
Interest income	**(17,897)**	(6,870)	(2,468)
Gain on disposition of property, equipment and lease rights	**(21,368)**	(17,316)	(923)
Sale of tax benefits	**–**	–	(13,046)
Other–net	**(4,028)**	(2,323)	(1,401)
	46,799	70,491	80,014
Earnings (loss) before income taxes and extraordinary items	**119,531**	29,511	(111,031)
INCOME TAXES	**50,300**	15,802	–
Earnings (loss) before extraordinary items	**69,231**	13,709	(111,031)
EXTRAORDINARY ITEMS			
Effect of utilization of tax loss carryforwards	**45,600**	15,802	–
Gain on pension plan termination	**62,175**	–	–
	107,775	15,802	–
NET EARNINGS (LOSS)	**$ 177,006**	$ 29,511	$ (111,031)
NET EARNINGS (LOSS) PER COMMON SHARE–PRIMARY			
Before extraordinary items	**$1.80**	$.30	$(4.28)
Extraordinary items	**2.94**	.46	–
Net earnings (loss)	**$4.74**	$.76	$(4.28)
NET EARNINGS (LOSS) PER COMMON SHARE–FULLY DILUTED			
Before extraordinary items	**$1.53**	$.29	$(4.28)
Extraordinary items	**2.45**	.46	–
Net earnings (loss)	**$3.98**	$.75	$(4.28)

The accompanying notes are an integral part of these statements.

Consolidated statements of changes in financial position

(in thousands)

	Year Ended December 31		
	1985	1984	1983
CASH AND SHORT-TERM CASH INVESTMENTS AT BEGINNING OF YEAR	**$123,143**	$ 59,781	$125,484
FUNDS PROVIDED			
Earnings (loss) before extraordinary items	**69,231**	13,709	(111,031)
Add non-cash items:			
Depreciation and amortization	**76,482**	74,008	70,625
Amortization of unearned compensation	**10,043**	6,024	–
Other	**3,881**	1,043	1,966
Net change in certain working capital items	**53,476**	21,749	(35,381)
Cash provided from (used in) operations, exclusive of extraordinary items	**213,113**	116,533	(73,821)
Extraordinary items	**107,775**	15,802	–
Extraordinary item not affecting cash	**(62,175)**	–	–
Cash provided from (used in) operations	**258,713**	132,335	(73,821)
Net book value of property and equipment dispositions	**4,335**	10,285	2,372
Increase in long-term obligations	**166,267**	2,181	30,887
Deferral of pension payments	**–**	22,088	23,010
Issuance of common stock and warrants	**11,289**	36	62,532
Other	**24,455**	6,386	4,875
	465,059	173,311	49,855
FUNDS USED			
Additions to property and equipment	**57,804**	15,926	59,969
Payment of long-term obligations	**183,222**	75,866	44,985
Redemption of preferred stock	**28,000**	–	–
Payment of cash dividends on preferred stock	**3,754**	4,550	1,820
Employee stock issued	**10,872**	–	–
Other	**4,465**	13,607	8,784
	288,117	109,949	115,558
INCREASE (DECREASE) IN CASH AND SHORT-TERM CASH INVESTMENTS	**176,942**	63,362	(65,703)
CASH AND SHORT-TERM CASH INVESTMENTS AT END OF YEAR	**$300,085**	$123,143	$ 59,781
INCREASE (DECREASE) IN CASH FROM CHANGES IN CERTAIN WORKING CAPITAL ITEMS			
Accounts receivable	**$ (48,915)**	$ 10,497	$ 1,284
Parts and supplies	**3,241**	10,864	(393)
Prepaid expenses and other	**(2,873)**	2,272	(1,021)
Air traffic liability	**43,986**	11,183	5,341
Accounts payable	**33,000**	2,288	(12,415)
Accrued expenses (1985 excludes pension liability relating to extraordinary item)	**25,037**	(15,355)	(28,177)
	$ 53,476	$ 21,749	$ (35,381)

The accompanying notes are an integral part of these statements.

Consolidated statements of changes in stockholders' equity

Years ended December 31, 1983, 1984 and 1985
(in thousands)

	Common Stock		Additional	Retained	Employee	Unearned
	Shares Issued	Amount	Paid-In Capital	Earnings (Deficit)	Stock to be Issued	Compen-sation
Balance at January 1, 1983	22,066	$4,413	$ 53,811	$ (30,286)	$ –	$ –
Cash dividends on redeemable preferred stock	–	–	–	(1,820)	–	–
Issuance of common stock and warrants	8,564	1,713	60,819	–	–	–
Net loss for 1983	–	–	–	(111,031)	–	–
Balance at December 31, 1983	30,630	6,126	114,630	(143,137)	–	–
Cash dividends on redeemable preferred stock	–	–	–	(4,550)	–	–
Issuance of common stock	9	2	34	–	–	–
Employee stock to be issued	–	–	–	–	26,571	(26,571)
Amortization of unearned compensation	–	–	–	–	–	6,024
Net earnings for 1984	–	–	–	29,511	–	–
Balance at December 31, 1984	30,639	6,128	114,664	(118,176)	26,571	(20,547)
Cash dividends on redeemable preferred stock	–	–	–	(3,754)	–	–
Exercise of stock options	110	22	398	–	–	–
Issuance of common stock under employee stock agreements	2,818	563	10,306	–	(10,872)	–
Tax benefit derived from issuance of employee stock	–	–	3,729	–	–	–
Amortization of unearned compensation	–	–	–	–	–	10,043
Net earnings for 1985	–	–	–	177,006	–	–
Balance at December 31, 1985	33,567	$6,713	$129,097	$ 55,076	$15,699	$(10,504)

The accompanying notes are an integral part of these statements.

Auditors' report

GrantThornton

Member Firm
Grant Thornton International

Stockholders and Board of Directors
Republic Airlines, Inc.

We have examined the consolidated balance sheets of Republic Airlines, Inc. (a Wisconsin corporation) and its subsidiary as of December 31, 1985 and 1984, and the related consolidated statements of operations, changes in stockholders' equity, and changes in financial position for the years ended December 31, 1985, 1984 and 1983. 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 consolidated financial position of Republic Airlines, Inc. and its subsidiary as of December 31, 1985 and 1984, and the consolidated results of their operations and changes in their financial position for the years ended December 31, 1985, 1984 and 1983, in conformity with generally accepted accounting principles applied on a consistent basis.

Minneapolis, Minnesota
February 17, 1986

Grant Thornton

Notes to financial statements

December 31, 1985, 1984, 1983

Note A – Summary of Significant Accounting Policies

1. Principles of Consolidation: The consolidated financial statements include the accounts of Republic Airlines West, Inc., a wholly owned subsidiary. All significant intercompany transactions have been eliminated. In December 1985, Republic Airlines West, Inc. completed a plan of dissolution whereby all of its remaining assets and liabilities were transferred to Republic Airlines, Inc.

2. Parts and Supplies: Spare parts and supplies relating to flight equipment are priced at average cost. An allowance for obsolescence ($16,213,000 at December 31, 1985, and $15,660,000 at December 31, 1984) is provided for repairable parts by allocating their cost over the life of the related aircraft.

3. Prepaid Expenses–Engine Overhaul: The Company reclassifies to a current prepaid expense the estimated portion of the purchase price of flight equipment attributable to its overhaul expected to be consumed within the next 12 months ($21,149,000 at December 31, 1985, and $21,070,000 at December 31, 1984). Actual overhaul costs are charged to expense as incurred.

4. Property, Equipment and Depreciation: Owned property and equipment are stated at cost. Property and equipment acquired under capital leases are stated at the lower of the present value of minimum lease payments or fair market value at the inception of the lease. Depreciation and amortization of property and equipment are based on the straight-line method. Estimated useful lives range from 10 to 20 years for flight equipment and 3 to 25 years for ground property and equipment. Residual values vary from zero to 15%. Property and equipment under capital leases and leasehold improvements are amortized over the lease term or the estimated useful life of the asset, whichever is less.

5. Deferred Charges: Expenses incurred in connection with the issuance of long-term obligations are deferred and amortized on a straight-line basis over the terms of the related obligations.

6. Passenger Revenue: Passenger revenue is recognized when the transportation service is provided. Tickets sold but unused are classified as a current liability.

7. Retirement Plan Costs: The Company has defined benefit and contribution plans covering all employee groups. Current service costs are accrued and funded on a current basis. For defined benefit plans, prior service costs are amortized over varying periods up to 40 years with funding determined under the unit credit, aggregate frozen liability, and individual entry age normal methods.

8. Income Taxes: The Company uses the flow-through method of accounting for investment tax credits which reduces income tax expense when the related liability is reduced. Investment credits not applied currently are offset against deferred income taxes to the extent they are applicable to previously deferred taxes becoming payable in the carryover periods. The Company recognizes deferred income taxes resulting from differences in financial and income tax reporting.

9. Reclassification: Certain amounts for 1984 and 1983 have been reclassified to conform with the 1985 financial statement presentation.

Note B – Sale of Tax Benefits – The leasing provisions of the Economic Recovery Tax Act of 1981 allowed the Company to enter into sale-leaseback transactions for income tax purposes involving certain equipment additions. As a result of these transactions, the Company recognized other income (net of related expenses) of $13,046,000 in 1983, $17,752,000 in 1982, and $28,930,000 in 1981. Provisions of these transactions include, among other things, indemnification of the buyer against loss of the stipulated tax benefit amount.

Note C – Long-Term Debt – All flight equipment and certain ground property and accounts receivable (accounts receivable of $38,060,000 at December 31, 1985, and $38,511,000 at December 31, 1984) are pledged as collateral against the long-term debt, consisting of the following at December 31 (in thousands):

	1985	1984
Bank Credit Agreement (a)	$185,895	$333,154
Installment notes (b)	142,021	140,507
Equipment trust notes:		
14-5/8% due February 1, 1990 (c)	73,056	–
15-1/8% due February 1, 1993 (c)	72,901	–
9% due May 1, 1993 (d)	23,550	26,700
Due July 1, 1998 (d)	6,746	7,265
Subordinated debentures (e):		
13% called in 1986	12,360	13,310
10-1/8% called in 1986	73,353	73,278
Sundry	3,354	3,764
Total long-term debt	593,236	597,978
Less current maturities (f)	83,802	59,696
	$509,434	$538,282

(a) The balance at December 31, 1985, is scheduled to be retired with quarterly installments aggregating $58,425,000 in 1986, $35,500,000 in 1987, $38,000,000 in 1988 and 1989, and a final payment of $15,970,000 in 1990. The Company is required to prepay indebtedness under the Bank Credit Agreement to the extent the Company achieves profits in excess of specified amounts, and from net proceeds from the disposition of flight equipment. Included in the 1986 aggregate quarterly installments is a prepayment of $29,425,000 due in April 1986. Interest is paid monthly to each participating bank at 1/2% over the Citibank, N.A. alternative rate or other rates as negotiated with the individual bank participants. The effective rate at December 31, 1985, was 10%.

Current covenants in the Bank Credit Agreement, as amended, require the maintenance of debt-to-equity ratios and place restrictions on dividend payments and capital expenditures. The most restrictive covenant requires the maintenance of minimum tangible net worth, as defined in the Bank Credit Agreement. The Company and the banks executed letter amendments and agreements during 1985 which amend the covenants and, based on assumed operating results, will allow the Company to remain in compliance over the remaining term of the loan.

The Company is required to maintain average compensating balances of 10% of the monthly average loan outstanding and to pay interest on any compensating balance shortfall at 1/2% over the Citibank, N.A. alternative rate. During 1985 the Company was required to maintain average compensating balances (adjusted for float) of $24,089,000. At December 31, 1985, the required compensating balance (adjusted for float) was approximately $21,611,000.

(b) Consists of various installment notes with final maturity dates from 1986 through 1998 at a weighted average interest rate of 15-1/4%. The aggregate installment payments in 1986 will be approximately $36,973,000 including interest.

(c) The equipment trust notes were sold at approximately 97% of face value (unamortized discount of $4,043,000 at December 31, 1985) with maturities of $75,000,000 on February 1, 1990, and February 1, 1993. These senior secured trust notes are secured by aircraft.

(d) The equipment trust notes due May 1, 1993, require semiannual sinking fund payments of $1,575,000 from 1986 through 1992 and $1,500,000 at maturity plus interest. The Company may make semiannual optional sinking fund payments up to $1,575,000 and may pay off the remaining balance in full on or after May 1, 1988, at a premium.

The equipment trust notes due July 1, 1998, require semiannual sinking fund payments of approximately $259,000 plus interest at rates ranging from 3/4% to 1-1/2% over the Citibank, N.A. alternative rate. The effective rate at December 31, 1985, was 10-1/4%. The Company may pay off the remaining balance in full at any time without a premium.

(e) The 13% convertible subordinated debentures due November 15, 1993, have interest payments due semiannually. The debenture holder may convert the principal to common stock of the Company at $11.84 per share (1,043,919 shares at December 31, 1985) subject to adjustment. The debentures were called for redemption in January 1986 (see Note M).

The 10-1/8% convertible senior subordinated debentures were issued at 97-1/2% of face value (unamortized discount of $1,646,000 and $1,722,000 at December 31, 1985 and 1984, respectively). Interest payments are due semiannually, and debenture holders may convert the principal to common stock of the Company at $10 per share (7,499,900 shares at December 31, 1985). The debentures were called for redemption in January 1986 (see Note M).

(f) Current maturities of all long-term debt due in each of the next five years following December 31, 1985, are as follows (in thousands):

1986	$ 83,802
1987	53,613
1988	57,397
1989	55,840
1990	106,891

Note D – Leases – The Company has lease commitments for flight equipment, various airport facilities, its main operating facilities, its maintenance and training facilities, and other property and equipment. The lease commitments for airport facilities are based upon space usage and landings and are subject to adjustment depending upon the needs of each airport operating authority and, therefore, certain amounts of the commitments are not determinable.

As of December 31, 1985, the Company leased 30 of its 168 aircraft, 18 of which were capital leases. Expiration dates range from 1986 to 2004. Under 24 of the lease agreements, the Company has the option to purchase the aircraft at the end of the lease term. The Company's obligations relating to the aircraft capital leases were $128,648,000 at December 31, 1985. In 1986, the aggregate payments for aircraft under capital leases will be approximately $18,976,000 including interest at a weighted average rate of 9-3/4%.

In addition, the Company has various types of ground property and computer equipment under capital lease agreements. The debt obligations relating to the capitalization of these leases were $4,784,000 at December 31, 1985. The aggregate payments in 1986 will be approximately $3,007,000 including interest at a weighted average rate of 13-1/8%.

During 1985, $90,500,000 of special facility airport revenue bonds were issued by a municipality to improve airport facilities which are being leased by the Company. The Company has guaranteed the bond payments. Lease payments of $325,373,000 approximate the principal and interest due under the bonds, net of estimated investment earnings. These payments are included in the table below under operating leases.

At December 31, 1985, future minimum lease payments under capital leases and noncancellable operating leases with initial or remaining terms of more than one year were as follows (in thousands):

	Operating Leases	Capital Leases
1986	$ 45,046	$ 21,983
1987	54,156	18,966
1988	53,162	18,777
1989	49,436	18,605
1990	46,155	18,845
Thereafter	749,438	129,431
Total minimum lease payments	$997,393	226,607
Less amounts representing interest		93,175
Present value of future minimum capital lease payments		$133,432

Rental expense under operating leases was $59,358,000 in 1985, $53,050,000 in 1984 and $50,444,000 in 1983.

Note E – Income Taxes – Income tax expense for the years ended December 31 was as follows (in thousands):

	1985	1984	1983
Federal	$44,200	$14,253	$ –
State and local	6,100	1,549	–
	$50,300	$15,802	$ –

Deferred income taxes of $2,020,000 were reinstated during 1984.

Differences between income tax expense and amounts derived by applying the statutory federal income tax rate of 46% to income before income taxes were as follows (in thousands):

	1985	1984	1983
Income tax expense (credit) at statutory federal income tax rates	$54,984	$13,575	$(51,074)
Investment credits	(12,254)	–	–
State and local taxes net of federal income tax benefit	6,100	1,549	–
Non-taxable permanent differences	1,396	668	797
Tax effect of net operating loss carryforwards not recognized	–	–	50,268
Other	74	10	9
	$50,300	$15,802	$ –

For federal income tax reporting purposes the Company and its subsidiary file separate tax returns. Republic Airlines, Inc. had, as of December 31, 1985, net operating loss carryovers of approximately $63,551,000 available to offset future taxable income, all of which expire in 1998. Investment tax credits of $45,860,000 are available to offset future income taxes payable and expire as follows: $9,041,000 in 1994; $17,120,000 in 1995; $6,035,000 in 1996; $4,099,000 in 1997; $2,905,000 in 1998; $3,324,000 in 1999; and $3,336,000 in 2000.

Republic Airlines West, Inc. had, as of December 31, 1985, net operating loss carryovers of approximately $71,897,000 available to offset future taxable income. Approximately $30,133,000 expires in 1994, $23,674,000 in 1995 and $18,090,000 in 1996. Investment tax credits of $7,179,000 are available to offset future income taxes payable and expire as follows: $370,000 in 1993; $4,481,000 in 1994; $402,000 in 1995; $1,724,000 in 1996; and $202,000 in 1997.

For financial reporting purposes, the Company and its subsidiary calculated income taxes on a consolidated basis. On this basis, as of December 31, 1985, there are approximately $23,000,000 of net operating loss carryovers available to offset future taxable income, and investment tax credit carryovers of approximately $30,000,000 are available to offset future tax provisions. Any future utilization of the preacquisition net operating losses or investment credits of Republic Airlines West, Inc. will be recorded as adjustments of the original purchase transaction. The Company has made certain stock contributions attributable to the 1985 plan years for the employee stock agreements (see Note I). These stock contributions result in a tax deduction in excess of the comparable book deduction, thereby creating a permanent difference. The tax benefit derived from this permanent difference was computed at current rates thereby utilizing approximately $12,000,000 of investment tax credits. This net tax benefit of $3,729,000 was charged to income tax expense and credited to additional paid-in capital.

The Internal Revenue Service has examined and cleared the Company's federal tax returns through December 31, 1979. During 1984, the Company reversed various tax liability accruals of approximately $2,000,000 which resulted from the settlement of an Internal Revenue Service examination.

Note F – Retirement Plans – The Company has retirement plans covering all employee groups. Pension expense for 1985, 1984, and 1983 was $17,889,000, $24,726,000 and $36,784,000, respectively. The Company has either made contributions to the plans equal to the amounts accrued for pension expense or has obtained minimum funding waivers from the Internal Revenue Service.

During 1984, 1983, and 1982, the Company obtained minimum funding waivers which are amortized over not more than 15 years. During 1985, the pilots' defined benefit pension plan was terminated and replaced with a defined contribution retirement plan. This termination resulted in the elimination of the Company's obligation to fund $62,175,000 of the waived amounts, which resulted in an extraordinary gain (see Note G). At December 31, 1985, the remaining unamortized liability, including accrued interest for pension waivers, was $22,497,000 of which $1,132,000 is due in 1986.

In 1984 the assumed rate of return used in determining the actuarial present value of accumulated benefits for all defined benefit pension plans was increased from 7-1/2% to 8-1/2% and remained at 8-1/2% during 1985. The effect of this change was to increase 1984 net earnings by approximately $8,714,000 or $.25 per share and to decrease the present value of plan benefits by approximately $35,542,000.

The accumulated plan benefits and plan net assets for all of the Company's defined benefit plans, except the pilots' plan which was terminated during 1985, were as follows (in thousands):

	January 1	
	1985	1984
Actuarial present value of accumulated plan benefits:		
Vested	$137,018	$124,944
Nonvested	4,465	3,790
	$141,483	$128,734
Net assets available for benefits	$123,824	$114,023

In addition to providing pension benefits, the Company provides certain health care benefits for retired employees. Substantially all of the Company's employees may become eligible for those benefits if they reach retirement age while working for the Company. The cost of retiree health care benefits is recognized as expense as claims are incurred. Those costs totaled approximately $3,000,000 in 1985 and $1,800,000 in 1984.

Note G – Pension Plan Termination – As part of an agreement with the Air Line Pilots Association, International, the Pilots Retirement Income Plan, a defined benefit pension plan, was terminated and replaced with a defined contribution retirement plan. The Company received approval from the Pension Benefit Guarantee Corporation and the Internal Revenue Service to terminate this plan. By June 30, 1985, annuities had been purchased to provide for all accrued pension benefits. Because plan assets exceeded fully vested benefits, no further funding was required by the Company. As a result, the Company was able to eliminate accrued but unfunded pension liabilities related to the Pilots Retirement Income Plan. The reversal of these accruals resulted in an extraordinary gain to the Company of $62,175,000 during the second quarter of 1985. Excess plan assets were allocated to plan participants in the form of additional benefits prior to application for termination of the Plan. There is no tax effect on the gain for financial reporting purposes, as the pension accruals were not deducted on Company tax returns.

Note H – Warrants, Options and Stock Appreciation Rights – During the second quarter of 1983, the Company issued 3,740,000 warrants in connection with a unit offering of common stock and warrants. The warrants, all of which were outstanding at December 31, 1985, enable the holders to purchase common stock at $10 per share through May 15, 1986.

In 1982 the Company granted 155,500 warrants to certain lenders in consideration for debt restructuring. The warrants, all of which were outstanding at December 31, 1985, enable the holders to purchase common stock at $8 per share through August 26, 1990.

On September 1, 1983, an officer of the Company was granted an option to purchase 25,000 shares of common stock at $4.25 per share. The entire option was exercised during 1985.

On February 24, 1984, an officer of the Company was granted an option to purchase 95,000 shares of common stock at $4.125 per share. The option is exercisable as follows: 50,000 shares on February 20, 1985, and 45,000 shares on February 20, 1986. The option expires February 24, 1992. During 1985, 25,000 shares of common stock were purchased under this option.

Stockholders approved a Stock Option and Stock Appreciation Right Plan (the "Plan") at the 1984 annual meeting. The Plan provides that options and/or stock appreciation rights may be granted to officers and key employees of the Company. An aggregate of 750,000 shares of common stock is reserved for issuance under the Plan upon exercise of options and stock appreciation rights. Amounts payable upon the exercise of stock appreciation rights are payable in cash or shares of common stock, as the Company may determine at the date of grant. A maximum of 750,000 options and 750,000 stock appreciation rights may be granted under the Plan.

The following table summarizes Plan activity:

	Stock Options	Stock Appreciation Rights	Price per Share
Outstanding at December 31, 1983	–	–	–
Grants	432,650	373,150	\$3.50 - \$5.375
Forfeitures	(20,100)	(9,600)	3.50
Outstanding at December 31, 1984	412,550	363,550	3.50 - 5.375
Grants	115,817	111,550	6.125 - 9.125
Exercises	(59,450)	(54,350)	3.50 - 5.375
Forfeitures	(29,400)	(29,350)	3.50 - 6.50
Outstanding at December 31, 1985	439,517	391,400*	3.50 - 9.125
Exercisable at December 31, 1985	106,900	85,717*	3.50 - 5.375

*Includes 35,000 rights exercisable for cash or common stock.

All of the stock options and stock appreciation rights granted under the Plan expire on various dates through 1995. Assuming any future stock appreciation rights are exercisable for cash only, as of December 31, 1985, an additional 304,250 stock appreciation rights were available for grant and there were 216,033 shares available for stock option grants under the Plan.

Note I – Employee Stock Agreement – During 1984 all of the Company's employee unions ratified amended labor agreements. The agreements provide for the extension of a 15% pay reduction and wage freeze through the contract amendable dates ranging from September 30, 1986, through March 31, 1987. Other terms of the agreements include additional wage and/or productivity concessions equivalent to 8% of payroll and certain pension plan changes. The Company's management employees are participating in similar concessions. In exchange for the concessions, the Company agreed to issue 5,529,195 shares of common stock and 7,230 shares of a new class of participating, non-cumulative, non-voting junior preferred stock with 2,170,000 callable warrant rights to purchase common stock at \$10 per share. As of December 31, 1985, 2,600,000 shares of common stock had been issued to trusts for the benefit of employees. The remaining shares of common stock and the junior preferred stock with warrant rights will be issued in 1986. Failure of the Company to restore the wage concessions may result in the issuance of additional junior preferred stock.

The junior preferred stock will not be publicly traded and represents a form of profit-sharing arrangement. The face amount will be \$10,000 per share, for a total of \$72,300,000. Participation will be through dividends based on a per share dividend rate of 1/10,000 of 15% of the Company's annual profit (as defined) in excess of \$20 million, commencing with the year 1985 (payable in 1986) and thereafter until the face amount has been paid, after which time the shares of preferred stock are convertible into 7,230 shares of the Company's common stock. The maximum participation in any one year will be limited to 15% of the original face amount. For purposes of determining participation, "profit" will be consolidated operating profit less interest expense and income taxes to be paid. The preferred shares will have liquidation preferences equal to 200% of the face amount, less all payments made thereon. Based on 1985 earnings, approximately \$6,800,000 of profit-sharing dividends will be payable in 1986. The Company records these dividends as expense during the year they are earned.

The warrant rights are callable when the trading price of the common stock averages \$15 per share for 20 consecutive trading days. One half of the warrant rights will be exercisable at any time from the date of issue through September 30, 1986. The remaining warrant rights will be exercisable from October 1, 1986, through September 30, 1990.

The estimated value of the securities described in the preceding paragraphs, as determined at the date of grant, was \$26,571,000 and is being amortized as additional compensation expense over the duration of the underlying employee agreements. During 1985 and 1984, the Company recorded amortization of \$10,043,000 and \$6,024,000, respectively.

The Company also agreed to fill one position on the Board of Directors with an individual of national prominence to be chosen by agreement of all the union groups and reasonably acceptable to the Company's Board of Directors. This Board member has not yet been selected by the union groups. The agreements also prevent the Company from paying dividends on common stock through December 31, 1986.

Note J – Net Earnings (Loss) Per Common Share – Primary earnings per common share for 1985, 1984 and 1983 were based on the weighted average number of common and common equivalent shares outstanding of 36,697,852; 34,139,472; and 26,720,591; respectively. In 1985 and 1984, common shares outstanding included 5,529,195 shares relating to employee stock agreements, of which 2,600,000 shares were issued in 1985 (see Note I). Common equivalent shares included 261,638 shares in 1985 and 46,220 shares in 1984 from the assumed exercise of stock options and warrants.

In 1985, fully diluted earnings per common share assumed conversion of the 10-1/8% convertible senior subordinated debentures into 7,499,992 shares, the 13% convertible subordinated debentures into 1,114,126 shares, and included 414,716 additional common shares from the assumed exercise of stock options and warrants. Fully diluted earnings per common share in 1984 included the assumed issuance of 228,975 additional common shares relating to the stock bonus plan for pilots and conversion of stock options. In 1983, fully diluted loss per common share was the same as primary, as the assumed conversion of convertible debentures and exercise of stock options and warrants were antidilutive.

Net earnings were reduced or net loss increased by preferred dividend requirements of $3,147,000 in 1985, $3,640,000 in 1984, and $3,337,000 in 1983 prior to computing the per common share amounts. In the fully diluted calculation for 1985, net earnings were adjusted for interest relating to the convertible debentures, net of income tax and profit-sharing effect. This amounted to $4,137,000 for net earnings per common share before extraordinary items, and $4,221,000 for net earnings per common share for the extraordinary items.

In January 1986 the Company's 10-1/8% convertible senior subordinated debentures were called for redemption (see Notes C and M). If these debentures had been converted into common stock as of January 1, 1985, primary earnings per share would have been $1.57 in 1985 before extraordinary items and $4.09 for net earnings.

Note K - Preferred Stock and Redeemable Preferred Stock of Subsidiary - During 1983, the Company authorized 25,000,000 shares of $.01 par value preferred stock. As of December 31, 1985, no preferred shares have been issued. These preferred shares are issuable in series with terms to be designated by the Board of Directors.

The Company's subsidiary, Republic Airlines West, Inc., had authorized 500,000 shares of $100 par value cumulative preferred stock. In February 1981, the subsidiary issued 280,000 shares in a private placement in connection with aircraft acquisition and financing transactions. Cumulative dividends were payable quarterly at an annual rate of $13 per share. The Company had the right to purchase the shares at any time at $100 per share plus all unpaid dividends. Effective with an amendment dated June 14, 1984, the stockholder could require the Company to purchase 17,500 shares quarterly beginning February 1, 1985, and exercised this option throughout 1985. During December 1985, all of the remaining outstanding shares were purchased by the Company. Following this purchase, Republic Airlines West, Inc. was dissolved, with the remaining net assets transferred to the Company.

Note L - Purchase Commitments - At December 31, 1985, the Company had on order three Boeing 757 aircraft and certain spare parts. Delivery of the aircraft is scheduled in 1986, with delivery of spare parts scheduled in 1986 and 1987. Deposits of $9,459,000 have been paid as of December 31, 1985. Future payments under these contracts approximate $102,685,000 and $3,284,000 in 1986 and 1987, respectively. The Company has options to purchase up to six additional Boeing 757 aircraft on which nonrefundable deposits of $1,560,000 have been paid. The delivery schedule of the option aircraft will be determined at the time the options are exercised. The Company may substitute Boeing 767 or 737-300 aircraft for the option aircraft. These options expire in December 1986.

The Company intends to obtain leveraged lease financing for the three Boeing 757 aircraft to be delivered in 1986, and consequently, the deposits on these aircraft are classified as current assets.

Note M - Subsequent Events

1. Proposed Acquisition by NWA Inc.: On January 23, 1986, after approval by the Executive Committee of the Board of Directors of the Company and the Board of Directors of NWA Inc. ("NWA"), the Company and NWA entered into an Agreement and Plan of Merger (the "Merger Agreement"), a Parent Stock Option Agreement, and a Company Stock Option Agreement. NWA is a holding company whose principal subsidiary is Northwest Airlines, Inc.

Pursuant to the Merger Agreement and subject to approval by the Company's stockholders, regulatory approvals, and other closing conditions, a wholly owned subsidiary of NWA will merge with the Company (the "Merger"). The Company will become a subsidiary of NWA. At the effective time of the Merger, shares of the Company's common stock will be converted into the right to receive in cash $17 per share. The Company's employees who hold stock options and stock appreciation rights will receive cash for each option or stock appreciation right share equal to the difference between $17 and the per share option or stock appreciation right exercise price.

Under the Parent Stock Option Agreement, the Company may purchase up to 2,500,000 shares of NWA common stock at a price of $46.125 per share. Under the Company Stock Option Agreement, NWA may purchase 9-1/2% of the shares of the Company's common stock outstanding immediately prior to exercise, excluding shares issued upon conversion of the Company's convertible debentures, at a price of $10.75 per share, and may exercise the right to receive appreciation (payable in cash or, subject to certain limitations, at the option of the Company, in shares of the Company's common stock) above $10.75 per share on an additional 9% of such outstanding shares. The options may be exercised only upon the occurrence of certain events. NWA paid the Company $5,000,000 for its option and will pay an additional $500,000 per month, up to an additional $2,500,000, following approval by the Company's stockholders, until the Merger is effected.

The Merger is subject to several conditions, including: (a) approval of the Merger by the Company's stockholders, (b) receipt of certain governmental approvals without any conditions or restrictions which have a material adverse effect on the financial condition, operations or prospects of NWA and the Company, (c) there being no material adverse change since September 30, 1985, in the financial condition of the Company, and (d) compliance with other closing conditions as set forth in the Merger Agreement. Prior to effecting the Merger, NWA will also offer positions on its Board of Directors to five persons currently serving on the Company's Board of Directors.

NWA has agreed to pay the Company an additional $2,500,000 if the Merger is not concluded for any reason other than failure of the Company's stockholders to approve the Merger or a material breach of the Merger Agreement by the Company. In the event of failure to obtain stockholder approval or a material breach by the Company, the Company must repay the option payments received from NWA.

The Company's stockholders will be voting on the Merger at the annual meeting scheduled for April 23, 1986. If stockholder approval is obtained and the other closing conditions are satisfied, the Company and the NWA subsidiary organized for the purpose of effecting the Merger will execute and file Articles of Merger with the Secretary of State of Wisconsin, at which time the Merger will be effective.

2. Redemption of 10-1/8% Convertible Senior Subordinated Debentures: In January 1986, the Company called for redemption all of its outstanding 10-1/8% convertible senior subordinated debentures. The debentures were subject to redemption on March 3, 1986, at $1,070.88 plus accrued interest of $21.66 for each $1,000 principal amount of debentures. The debentures were convertible into common stock at $10 per share. The right to convert the debentures expired at the close of business on February 14, 1986, and $74,424,000 principal amount of the debentures was converted.

The Company made arrangements with an investment banking firm whereby the firm agreed to acquire from the Company all of the shares of stock that would have been delivered upon conversion of the debentures, for those debentures that were either surrendered for redemption or for which no action was taken prior to the conversion termination or redemption dates.

3. Redemption of 13% Convertible Subordinated Debentures: In January 1986, the Company called for redemption all of its outstanding 13% convertible subordinated debentures. The debentures are to be redeemed on April 15, 1986, at 105% of the principal amount plus accrued interest. The debentures are convertible into common stock at $11.84 per share. The right to convert the debentures expires at the close of business on March 31, 1986.

Supplemental stockholder information

QUARTERLY SUMMARIES OF OPERATIONS

(unaudited–in thousands, except per share amounts)

	1985 Three Months Ended				1984 Three Months Ended			
	December 31	September 30	June 30	March 31	December 31	September 30	June 30	March 31
Operating revenues	$449,343	$448,558	$455,591	$380,905	$357,611	$385,514	$410,489	$393,618
Operating expenses	417,075	398,264	389,834	362,894	348,334	357,015	366,758	375,123
Operating profit	32,268	50,294	65,757	18,011	9,277	28,499	43,731	18,495
Earnings (loss) before extraordinary items	2,669	24,164	39,992	2,406	(5,667)	6,138	17,291	(4,053)
Extraordinary items:								
Effect of utilization of tax loss carryforwards	10,553	14,220	17,980	2,847	(4,365)	8,437	11,730	–
Gain on pension plan termination	–	–	62,175	–	–	–	–	–
Net earnings (loss)	13,222	38,384	120,147	5,253	(10,032)	14,575	29,021	(4,053)
Earnings (loss) per common share–								
Primary:								
Before extraordinary items	.05	.63	1.07	.04	(.18)	.15	.50	(.16)
Net earnings (loss)	.34	1.02	3.26	.12	(.30)	.38	.85	(.16)
Fully diluted:								
Before extraordinary items	.06	.54	.90	.04	(.18)	.14	.42	(.16)
Net earnings (loss)	.32	.87	2.68	.12	(.30)	.36	.73	(.16)

EFFECTS OF CHANGING PRICES (unaudited)

Basis of preparation of 1985 supplemental data

As required by the Financial Accounting Standards Board (FASB), the Company has provided supplemental information concerning the effects of changing prices on its financial statements. The disclosures are intended to address the specific price changes in the individual resources used by the Company.

Calculations derived from application of the FASB requirement involve a substantial number of judgements, as well as use of various estimating techniques that have been employed to limit the cost of accumulating the data. The data reported should not be thought of as precise measurements of the assets and expenses involved, but as reasonable approximations of the price changes that have occurred in the business environment in which the Company operates.

The current cost method of accounting adjusts for specific changes in prices of spare parts inventory, property and equipment, and gain or loss from disposition of property and equipment. These assets are stated at their current cost (rather than historical cost) at the balance sheet date.

Current cost asset amounts were derived principally through a reference guide to current selling prices supplied by the Air Transport Association. Current cost depreciation is based on the average current cost of property and equipment during the year. Depreciation expense was computed by applying the ratio of historical depreciation expense to average historical asset cost, to the average current cost of these assets. The result should be approximately the same as would be calculated using the depreciation methods used in preparing the primary financial statements. Current cost does not purport to represent the amount at which the assets could be sold.

Current tax laws do not recognize deductions for current cost of depreciation and amortization expense, therefore, income taxes provided are reported in historical dollars as required.

The gain from the decline in purchasing power was determined by calculating the changes in monetary assets and liabilities by utilizing the change in the Consumer Price Index for the year. In times of inflation, there is a purchasing power loss in holding monetary assets such as cash and receivables and a purchasing power gain in holding monetary liabilities such as debt and payables.

Data developed in compliance with the FASB requirement is of an experimental nature and should be viewed in that context. Caution should be used in analyzing and drawing conclusions from this data.

CONSOLIDATED STATEMENT OF OPERATIONS —ADJUSTED FOR CHANGING PRICES

Year ended December 31, 1985 (in thousands–unaudited)

	As Reported in the Primary Statements	Adjusted for Changes in Specific Prices (Current Cost)
Total operating revenues	$1,734,397	$1,734,397
Depreciation and amortization	76,482	188,877
Other operating expenses	1,491,585	1,492,668
Gain on disposition of property, equipment and lease rights	(21,368)	(15,541)
Other expenses–net	68,167	68,167
Income taxes	50,300	50,300
	1,665,166	1,784,471
Earnings (loss) before extraordinary items	$ 69,231	$ (50,074)
Gain from decline in purchasing power of net amounts owed		$ 27,365
Increase in specific prices (current cost) of inventory and property and equipment held during the year*		$ 127,906
Effect of increase in general price level		57,386
Excess of increase in specific prices over increase in general price level		$ 70,520

*At December 31, 1985, current cost of inventory was $37,519,000 and the current cost of net property and equipment was $1,802,282,000, compared with $35,657,000 and $738,332,000 in the historical financial statements, respectively.

FIVE-YEAR COMPARISON OF SELECTED SUPPLEMENTARY FINANCIAL DATA —ADJUSTED FOR EFFECTS OF CHANGING PRICES

(In average 1985 constant dollars, in thousands except per share and price index amounts–unaudited)

	Year Ended December 31				
	1985	1984	1983	1982	1981
Total operating revenues	$1,734,397	$1,602,437	$1,632,049	$1,705,919	$1,713,215
Current cost information:					
Loss before extraordinary items	$ (50,074)	$ (130,210)	$ (220,748)	$ (131,193)	$ (123,039)
Per common share	$ (1.16)	$ (3.90)	$ (8.39)	$ (6.14)	$ (5.92)
Excess of increase in specific prices over increase in general price level	$ 70,520	$ 78,395	$ 82,546	$ 74,628	$ 148,285
Net assets at year end	$1,217,931	$1,236,548	$1,226,242	$1,266,126	$1,022,957
Other information:					
Gain from decline in purchasing power of net amounts owed	$ 27,365	$ 35,749	$ 36,350	$ 37,213	$ 81,149
Cash dividends declared per common share	–	–	–	–	$ .12
Market price per common share at year end	$ 10.21	$ 5.49	$ 3.98	$ 8.68	$ 4.72
Average consumer price index (1967=100)	322.2	311.1	298.4	289.1	272.4

FORM 10-K REPORT

For the Form 10-K report filed with the Securities and Exchange Commission, write Mr. A. L. Maxson, Senior Vice President–Finance, Republic Airlines, Inc., 7500 Airline Drive, Minneapolis, MN 55450.

COMMON STOCK INFORMATION

The following tabulation sets forth the price range for the Company's common stock which is traded on the New York Stock Exchange and the Midwest Stock Exchange.

	1985		1984	
	High	Low	High	Low
1st Quarter	$ 6-5/8	$5-1/8	$5-1/4	$3-3/4
2nd Quarter	8-7/8	5-7/8	4-1/8	3-1/4
3rd Quarter	10-3/4	8	5-1/8	3-5/8
4th Quarter	12-1/8	8-1/4	5-3/4	4-1/2

The Company has not paid any cash dividends on common stock since 1981. Certain of the Company's debt agreements restrict payment of dividends on or the repurchase of common stock until certain financial loan covenants are met. Under the employee stock agreement, the Company cannot pay dividends on common stock through December 31, 1986. At February 28, 1986, the Company had 29,606 holders of common stock.

ANNUAL MEETING

Wednesday, April 23, 1986

REGISTRARS AND TRANSFER AGENTS

Norwest Bank Minneapolis, N.A.
Minneapolis, Minnesota 55480
Norwest Trust Company
New York, New York 10005

SECURITIES LISTED

Common Stock (RAI)
New York Stock Exchange
Midwest Stock Exchange
Warrants (RAIW)
New York Stock Exchange

AUDITORS

Grant Thornton (formerly
Alexander Grant & Company)

Board of Directors and Officers

Directors

Daniel F. May
Chairman of the Board
Republic Airlines, Inc.

Cecil A. Beasley, Jr.
Attorney at Law
Washington, D.C.

Hal N. Carr
Chairman of the Executive Committee
Republic Airlines, Inc.

David H. Hughes
President
Hughes Supply, Inc.
(Electrical and plumbing supplies)
Orlando, Florida

Frank W. Hulse
Retired Vice Chairman of the Board
Republic Airlines, Inc.

John M. Lawrence III
Attorney at Law
Bryan, Texas

Morton B. Phillips
Chairman of the Board and President
OMI, Inc.
(Business investments)
San Francisco, California

G. Frank Purvis, Jr.
Chairman of the Board
Pan American Life Insurance Co.
New Orleans, Louisiana

Henry M. Ross
President
Ross Industries, Inc.
(Machinery manufacturer)
Midland, Virginia

Bernard Sweet
Retired Vice Chairman of the Board
Republic Airlines, Inc.

Richard A. Trippeer, Jr.
Chairman of the Board
Union Planters Corporation
(Bank holding company)
Memphis, Tennessee

Wm. Bew White, Jr.
Counsel to Bradley, Arant,
Rose & White
(Attorneys at Law)
Birmingham, Alabama

Stephen M. Wolf
President and Chief Executive Officer
Republic Airlines, Inc.

Frank M. Young III
Partner—Haskell Slaughter
Young & Lewis
(Attorneys at Law)
Birmingham, Alabama

Executive Committee

Hal N. Carr
Chairman
Frank W. Hulse
Daniel F. May
Henry M. Ross
Wm. Bew White, Jr.
Stephen M. Wolf

Audit Committee

G. Frank Purvis, Jr.
Chairman
John M. Lawrence III
Frank M. Young III

Stock Option Committee

Richard A. Trippeer, Jr.
Chairman
Hal N. Carr
David H. Hughes

Officers

Daniel F. May
Chairman of the Board

Stephen M. Wolf
President and Chief Executive Officer

Gramer D. Foster
Senior Vice President-Operations

A. B. Magary
Senior Vice President-Marketing

A. L. Maxson
Senior Vice President-Finance

Henry W. Barkhausen
Vice President and Treasurer

Arnold J. Grossman
Vice President-Marketing Systems

Paul C. Jasinski
Vice President, General Counsel and
Assistant Secretary

W. Thomas Lagow
Vice President-Marketing Planning

Gary H. Lantner
Vice President and Secretary

Lee R. Mitchell
Vice President-Computer and
Communications Service

Bruce R. Nobles
Vice President-Customer Service

R. Terrence Rendleman
Vice President-Maintenance and
Engineering

Paul E. Schoellhamer
Vice President-Government Affairs

Raymond W. Sellwood
Vice President-Flight

Michael D. Meyer
Controller

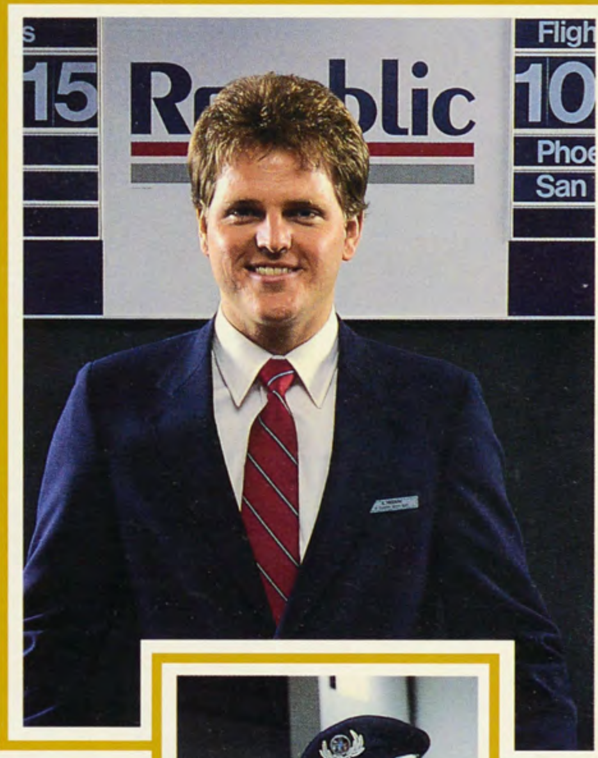
Joseph W. Ettel
Assistant General Counsel and
Assistant Secretary

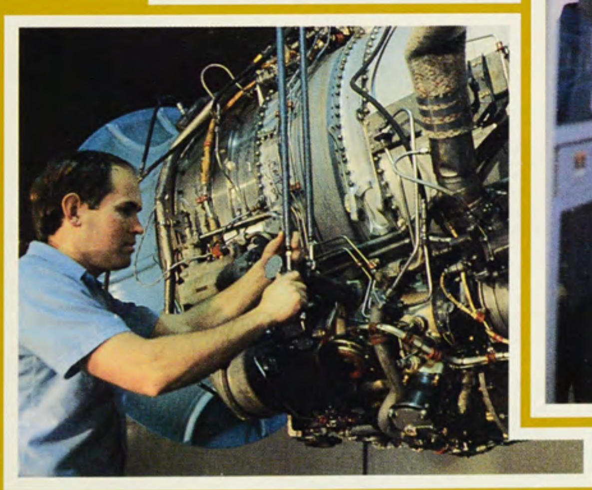
Walter E. Nielsen
Assistant Treasurer

Gloria B. Olsen
Assistant General Counsel and
Assistant Secretary

Ralph Strangis
Assistant Secretary

The key element in Republic's success has been highly motivated, professional employees both in customer-contact positions at gates, ticket counters, aboard aircraft and at reservations centers, as well as behind the scenes in computer rooms, maintenance bases and hundreds of other key locations – all working to make Republic the airline of preference among frequent business travelers.





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