1969 Annual Report

the year of preparation

New Jet Routes Span
the Eastern United States.

STOCKHOLDERS, CUSTOMERS, EMPLOYEES AND FRIENDS:

The year 1969 was perhaps the most significant year of progress in the history of our Company, in spite of disappointing financial results. During the period Southern received major route awards which substantially expanded the area we serve, and which will enable us to participate in vastly stronger markets.

The Civil Aeronautics Board extended our system to Chicago, St. Louis, Tallahassee, Orlando and Miami and granted the Company, for the first time, authority to provide non-stop service in many long-haul markets. Some of these are Chicago-Memphis, Miami-Memphis, and Miami-Birmingham. Our present system now consists of 8,061 unduplicated route miles, more than twice the route mileage at the beginning of 1968. Company routes now serve fifty-six airports of thirteen states in a service area bounded by New York, Miami, Chicago and New Orleans.

Although we achieved record high revenues of $37,835,508, we incurred a loss of $821,928. The revenue increase of 29 percent over 1968 was simply insufficient to overcome increased costs of 30 percent; these costs were chargeable in part to building for the future.

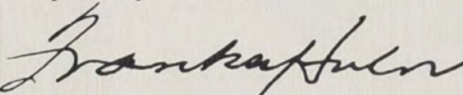
Aside from relatively minor start-up costs in connection with the inauguration of Chicago service on April 1st, the major costs of expanding our system, training personnel, and obtaining new equipment were incurred in 1969 and the first quarter of 1970. Likewise, much of the developmental costs of new markets is behind us.

To provide service over our dramatically expanded system, we have increased the jet fleet from seven Douglas DC-9 aircraft at January, 1969 to fifteen DC-9's today. In a continuing effort to upgrade service and improve efficiency, Southern operated 60 percent of its 1969 seat miles with jet equipment. This will be expanded to 80 percent in 1970.

In a further step designed to meet our new and enlarged responsibilities, we realigned the Company organizational structure during 1969. The principal change was the creation of the Office of the General Manager, with the responsibility of the day-to-day operation of the Company. Reporting directly to the Office of the General Manager are seven divisional level positions including Flight Operations, Technical Services, Sales and Marketing, Customer Services, Computer Services, Personnel and Fiscal.

Although our Company, like most other air carriers, is confronted with the declining traffic growth and the problems of inflation, nontheless our future today appears brighter than at any time in the past. Our system has, in effect, been doubled, and we have been awarded access to the most important traffic generating cities in the eastern half of the United States. Southern Airways today offers a long range potential of public service and in turn, for profits far and above those at any time in the past.

Respectfully Submitted,



Frank W. Hulse,
President

March 26, 1970

FINANCIAL REVIEW

As a result of service being extended to Washington, D.C. and New York in the latter part of 1968 and to St. Louis in mid 1969, Southern's revenues reached new highs during 1969, with an overall gain over the previous year of 29 percent. These revenue increases, however, did not offset the increase in operating expenses resulting from initial costs associated with developing new routes plus the general inflationary trend experienced during the year. The major contributing factors to the $821,928 loss in 1969 were higher operating expenses and greatly increased interest expense together with reduced revenue growth in the fourth quarter of 1969 brought on by a softening in the nation's economy.

Commercial Revenues

Total passenger revenues for 1969 were $28,050,097—highest in your Company's history—and a 37 percent increase over the previous year. This increase is attributable not only to the 27 percent increase in revenue passenger miles developed during the year, but also to an increase in yield per revenue passenger mile as a result of two fare adjustments which are discussed later in this report.

Cargo (mail, express and freight) increased 11 percent in 1969 to $2,163,178.

Charter sales continued to be one of the strongest sources of added revenue for your Company. This area increased 74 percent to $3,358,146 in 1969, and was obtained primarily through committing a second DC-9 aircraft to full time charter service.

Public Service Revenue

Public Service Revenue (subsidy) decreased during the year from $4,038,298 in 1968, to $3,579,639 in 1969. More significantly, subsidy, as a percent of total operating revenues, decreased from 14 percent in 1968 to 9 percent in 1969; hence your Company's dependence on subsidy continued to decline. Per passenger carried, subsidy decreased from $3.18 in 1968 to $2.60 in 1969.

The Civil Aeronautics Board has issued an order, effective December 29, 1969, eliminating further reductions in subsidy arising from the theoretical profit to be derived from future improvements in operating authority awarded by the Board. While this change did not provide any immediate gain to Southern, it will be of benefit should Southern be awarded additional route authority.

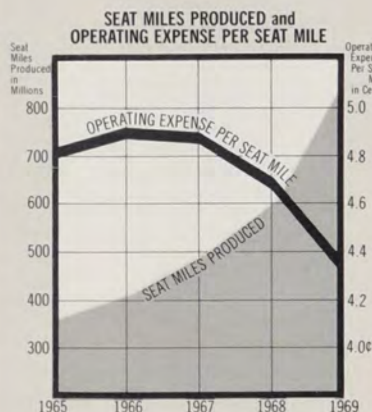
On February 5, 1970, the Local Service Industry filed a request with the CAB for a moratorium on the use of the revenue sharing factor in computing future subsidy payments. Should this request be granted expeditiously, it would have the effect on Southern of stabilizing 1970 public service revenues at a level only slightly less than that for 1969.

Operating Expenses

Operating expenses totaled $37,409,160, up 30 percent over 1968. Total available seat miles increased 41 percent as a result of introduction of additional DC-9s to accommodate the new service into New York and St.

FIVE YEAR COMPARISON	1969	1968	1967	1966	1965
OPERATING STATISTICS					
Passengers (scheduled service)	1,377,421	1,271,497	1,180,297	1,051,554	848,149
Passenger Miles (000) (scheduled service)	323,472	254,028	222,142	196,366	156,421
Plane Miles (000)	14,679	12,260	11,803	11,287	10,611
Available Seat Miles (000)	862,388	611,795	498,322	416,738	374,757
Cargo Ton Miles	3,677,374	3,018,209	2,593,645	2,281,380	1,763,784
Completion Factor	97.2%	98.1%	97.8%	98.5%	98.5%
Average Passenger Load (scheduled service)	24.3	22.3	19.4	18.0	15.3
Passenger Load Factor (scheduled service)	42.4%	45.8%	45.9%	48.6%	43.2%
Average Length of Passenger Haul	234.8	199.8	188.2	186.7	184.4
Employees At End Of Year	1,747	1,538	1,499	1,365	1,248
FINANCIAL STATISTICS					
Employee Wages and Benefits (000)	$ 17,197	$ 14,240	$ 12,582	$ 10,800	$ 9,516
Commercial Revenues (000)	$ 34,256	$ 25,262	$ 20,000	$ 17,513	$ 14,688
Net Income (Loss) (000)	$ (822)	$ (211)	$ (238)	$ 807	$ 938
Stockholders' Equity (000)	$ 4,248	$ 5,070	$ 4,849	$ 4,937	$ 4,291
Common Shares Outstanding	1,024,871	1,024,871	1,024,871	1,005,000	1,005,000[1]
Book Value per Share	$ 4.14	$ 4.95	$ 4.73	$ 4.91	$ 4.27[1]
Net Income per Share (Loss)	$ (.80)	$ (.21)	$ (.23)	$ .80	$ .93[1]

[1]Adjusted to reflect three-for-two stock split in May 1966.



Louis and to provide additional charter capability. Operating expenses per available seat mile decrease from 4 cents in 1968 to 4.3 cents in 1969.

Also contributing to the increase in expense was the continuing upward spiral of costs for labor, material and services. Employee wages and benefits increased 21 percent, depreciation, amortization and aircraft lease rentals 67 percent: fuel 39 percent and other operating expenses 32 percent.

Interest Expense

Interest on debt was $1,719,541 contrasted to $1,135,812 in the preceding year. This reflects the added costs associated with the $8,000,000 debenture issue placed in November 1968, plus the increase in interest rates on bank debt previously outstanding.

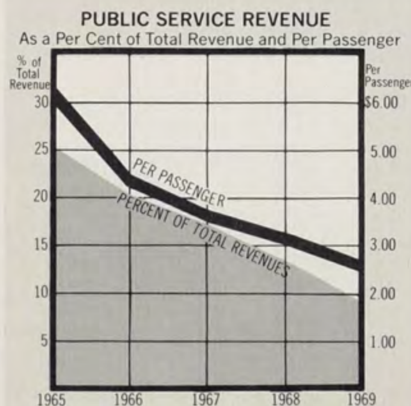
Income Taxes

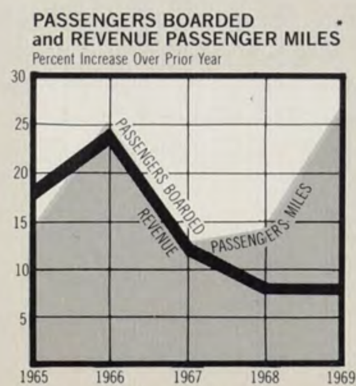
1969 results include the provision for refund of federal income taxes of $486,961 resulting from the carryback of 1969's net operating loss to prior years. In addition, the Company uses accelerated depreciation methods on certain of its aircraft and at December 31, 1969 it had a net operating loss carryforward to be used to offset income of future years amounting to approximately $1,025,000. The Company also has an available investment tax credit carryforward of $1,220,000 to offset future federal income tax liability.

Aircraft Acquisition and Financing

The Company received delivery of a new 95-passenger DC-9-30 jet aircraft during each of the months of April, May and June 1969. The aircraft received in April was purchased out of the proceeds of the $8,000,000 debenture issue sold in November 1968. The aircraft received in May and June were acquired under a twelve-year lease which provides for the full payout of the purchase price of the aircraft over the lease period, assigns the investment tax credit to the lessors, and provides a fair market purchase option to the Company at the end of the lease term.

The Company has entered into short-term lease agreements for five additional DC-9-10 jet aircraft, bringing to six the number of aircraft under such lease arrangements. In general, the lease agreements provide for initial lease terms of six months with renewal options for 23 additional six-month periods. Accordingly, Southern now has sufficient equipment to meet its system capacity requirements for 1970 under all reasonable traffic growth assumptions. However, the Company anticipates that these leased aircraft will be returned over the next several years and replaced with new 95 passenger DC-9-30 aircraft as traffic warrants and financing is arranged.





Yields and Fare Increases

System yield increased from 8.1 cents per revenue passenger mile in 1968 to 8.7 cents per revenue passenger mile in 1969 even though the average length of haul of each passenger increased from 199.8 miles in 1968 to 234.8 miles in 1969. This increase in yield is attributable to fare increases during 1969; the first effective February 20, 1969 which provided Southern with approximately a 13 percent increase, and the second effective October 1, 1969 which produced about a 7 percent increase.

These fare increases played a significant part in minimizing the losses of not only Southern but the entire Local Service Industry and were needed by all carriers, especially those having short haul characteristics, to more properly offset the actual cost of providing air service.

Effective February 1, 1970 the CAB approved a proposal of the airlines for developing new joint fares in all markets having over 200 passengers per quarter and not currently having such joint fares and also dividing the revenue obtained under joint fares between the long haul and short haul carriers. Preliminary estimates indicate that the combined net effect of the new joint fares and new method of dividing interline revenue will not have a significant effect on Southern's passenger revenues.

1969's LABORS REAP HARVEST OF NEW ROUTES FOR 1970

From an operating authority standpoint, the year 1969 was probably the most significant for your Company in its 20-year history. Of four route proceedings pending at the first of 1969, three of these were concluded successfully.

The *Southern Airways, Inc. Route Realignment Investigation*, in which your Company sought to improve its operating authority within its historic service area, as well as the extension of its system down the Florida peninsula to Key West, was divided into two parts: "Realignment"and "Extension."

The realignment portion, improving the then existing operating authority by reducing the number of segments from 15 to seven, was approved by the Civil Aeronautics Board on February 20, 1969, and the authority became effective April 21, 1969.

In the extension portion of the proceeding your company sought authority to serve between Tallahassee, Orlando, Miami/Ft. Lauderdale, Marathon, Key West and a number of the larger traffic-producing points on our present system, including Memphis, Birmingham, Huntsville and Atlanta. On September 25, the CAB released its decision granting Southern permission to serve Tallahassee, Orlando, and Miami/Ft. Lauderdale. Although we were not awarded as much of the Atlanta authority as we sought, unrestricted authority was granted between numerous points west of Atlanta and the Florida markets such as nonstop authority between Miami and both Memphis and Birmingham. Permission to operate this service became effective November 24, 1969, and service commenced February 15, 1970.

In the Central Route 81 Case, the CAB, on May 8, 1969, approved Southern's bid for Memphis-St. Louis authority. Although unsuccessful carrier applicants caused a delay for many of the route awards in the proceeding through requests for CAB and court stays, the service was implemented July 7, 1969, and traffic continues to grow.

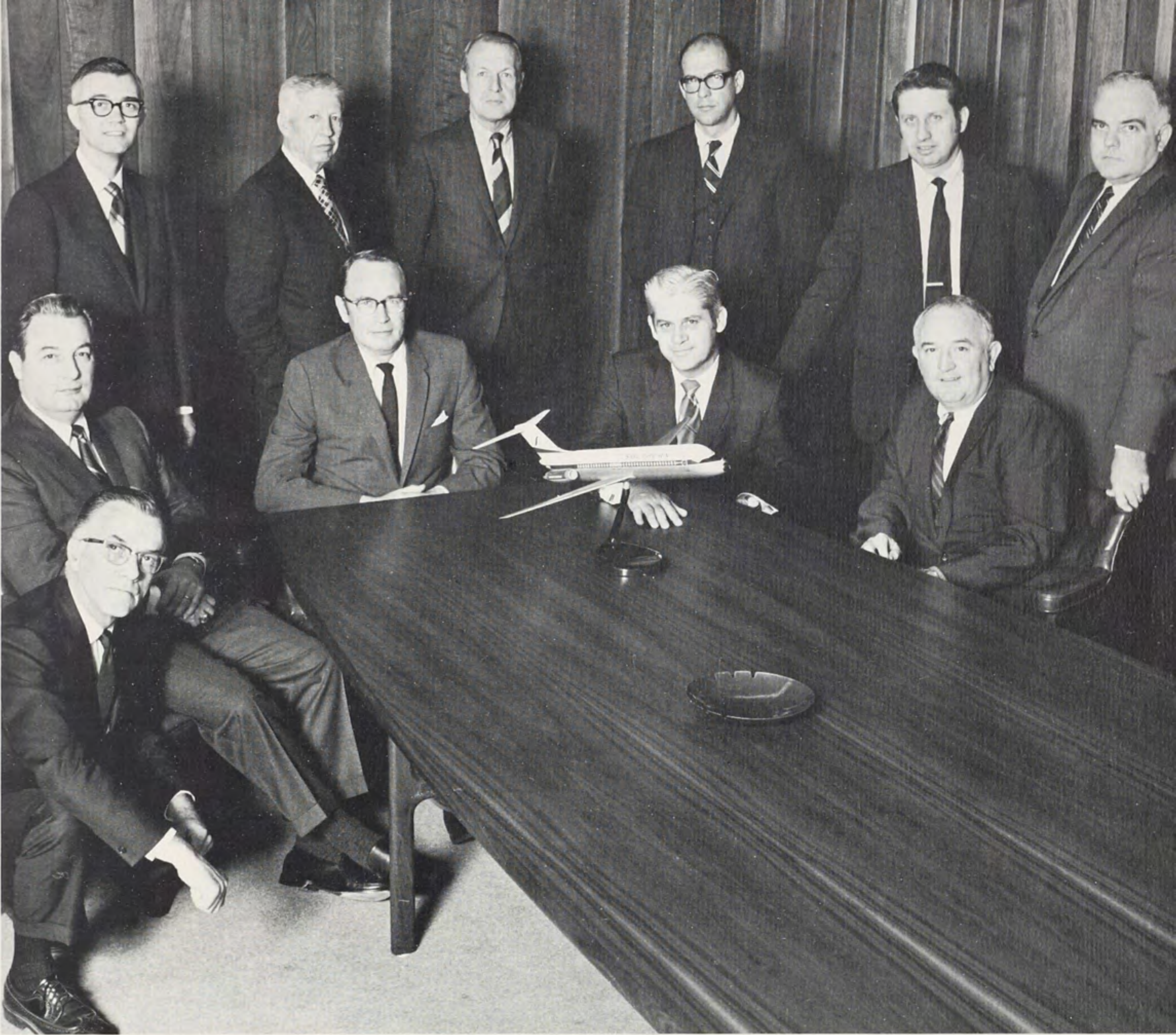
In the *Gulf States-Midwest Points Service Investigation*, on May 7, 1969, the CAB granted the Company Memphis-New Orleans nonstop authority, but denied your Company authority to operate in the lucrative Memphis-Chicago market. Southern vigorously opposed the award of this Chicago authority to another applicant and, on September 5, 1969, the CAB issued its decision on reconsideration, taking the unusual step of reversing its earlier decision with respect to Chicago and awarded Southern nonstop Memphis-Chicago authority. Permission to operate the Chicago service became effective on November 18, 1969 and service began April 1, 1970.

The fourth and final proceeding pending at the beginning of 1969 was the *Southern Tier Competitive Nonstop Investigation* in which Southern sought entry into the Dallas/Ft. Worth market. Unfortunately, major trunkline carriers were selected for the majority of routes awarded and the Company was unsucessful in this endeavor.

In its first bid, using an expedited procedural method of the CAB, your Company was signally successful in its efforts to link the Gulfport/Biloxi area into the Washington and New York markets. Our application was filed on June 25, 1969, and on September 19, 1969 final operating authority was approved. The then operating Washington and New York flights were extended to Gulfport/Biloxi beyond Eglin AFB so that we are able to carry the Gulfport-New York passenger and earn revenues for his entire trip of some 1,100 miles while only incurring expenses of operating 146 miles between Gulfport/Biloxi and Eglin AFB. The new service to Gulfport/Biloxi began October 26, 1969, and this service has been an important factor in assisting the rebuilding of the Gulf Coast area which was ravaged August 17, 1969 by hurricane "Camille."

As 1969 drew to a close your Company was participating in three other route proceedings, the *North Carolina Points Service Investigation* and *Additional Service to Augusta and Columbia Case*. Both these proceedings involve possible additional operating authority to New York and the latter proceeding to Washington as well. In both instances, a CAB Hearing Examiner has recommended in favor of other applicants. Nevertheless your Company is continuing to pursue this possibility of augmenting its current Washington and New York operations.

Additionally, another proceeding, the *Atlanta-Detroit/Cleveland/Cincinnati Investigation*, was in the initial stages. Your Company is actively seeking nonstop authority between Atlanta and both Cleveland and Detroit. A final CAB decision in this proceeding is not expected until early 1971.



Left to right—(kneeling) Richard N. Harbottle; (seated) George M. Gross, Graydon Hall, John J. Janisch, T.A. Wiley, Jr.; (standing) Everett L. Martin, W. Bayne Grubb, W.S. Magill, Jr., A.L. Maxson, David Russell, J. Kenneth Courtenay.

COMPANY CORPORATE STRUCTURE REORGANIZED TO PREPARE FOR THE '70s

The past year saw your Company reorganize its structure to streamline and improve the efficiency of its day-to-day operations, and enable your Company to capitalize effectively on the new opportunities ahead. Implementing the plan which was developed with the assistance of a leading management consulting firm, your Company established seven new divisional levels. The heads of these divisions report to the newly created Office of the General Manager. Graydon Hall was elected executive vice president and general manager, and George M. Gross, vice president and associate general manager.

The seven new divisions and their heads are: *Technical Services*, Richard N. Harbottle, Vice President; *Flight Operations*, W. Bayne Grubb, vice president; *Customer Services*, John J. Janisch, vice president; *Sales and Marketing*, T. A. Wiley, Jr., vice president; *Computer Services*, David Russell, Director; *Personnel*, Everett L. Martin, assistant vice president; and *Fiscal*, A. L. Maxson, Treasurer.

Also reporting to the Office of General Manager are the departments of System Planning, Contracts-Properties, Government Relations and Public Relations.

The Office of Economic Regulations Division, headed by J. Kenneth Courtenay, vice president and secretary, will continue to report directly to Southern's president, Frank W. Hulse.

SALES AND MARKETING ACTIVITIES BROADENED FOR THE FUTURE

The year 1969 has seen your Company change from an airline operating primarily in small city markets to one also serving the most sophisticated air markets in the United States. Accordingly, it has been necessary to redirect many approaches both in how we sell our customer and in the service we provide to our customer.

Within our Sales and Marketing Division we have added new functions. A Marketing Analysis Department has been created with the responsibility of conducting surveys of both present and potential markets in order to determine the best revenue opportunities for your Company. A program of customer surveys provides the passengers' reaction to our services and this information will be used as a basis for upgrading the quality of services provided to our passengers. Our new Customer Service Standards and Specifications Department is responsible for measuring the quality of our services against rigid standards which have been set at levels equal to or higher than our competitors.

The Field Sales Department was strengthened during the year with special emphasis being placed on locating sales representatives in those cities in which Southern has the greatest potential for increased revenues.

Susanna Southern promotes "Southern Style."

Service to St. Louis through Memphis from New Orleans and intermediate points was inaugurated during July of 1969. During the last six months of the year, 66,663 passengers were carried on flights serving St. Louis resulting in revenues of about $1,500,000, approximately 10% of the total system's passenger revenue for that period. While the results fell short of our forecast, we have successfully established our identity in the St. Louis market, and we are effectively competing with one of the larger trunk lines.

A great deal of effort in the second half of 1969 was devoted to the preparation of schedules for service to be introduced during 1970 for the new flights to Chicago and through the Florida Peninsula to Miami. As a result of this preparation, we have been able, well in advance of the inauguration of service, to plan an effective campaign to obtain a satisfactory penetration of each new market. For example, we are currently realizing more traffic than was forecasted in the new Florida markets.

While changing economic conditions have made realization of our 1970 traffic forecast more difficult, we are confident that we will obtain satisfactory traffic levels not only from new route authorities, but also from the basic system which we have served for many years.

During 1969, in selected major cities, your Company departed from its advertising philosophy of using a combination of advertising media. In these metropolitan areas television was used exclusively to sell your Company's services. Throughout the year, surveys were conducted to measure the effectiveness of this television advertising. Results indicated the commercials were creating the desired awareness of your Company and its services.

In keeping with the new accent on marketing, your Company has analyzed the population profile and the advertising media in every market it serves. For 1970, this information has been used to select the media which reaches the highest percentage of Southern's potential customers.

Atlanta City Ticket Office

New Reservation Computer

CUSTOMER SERVICES IMPROVED BY COMPUTER AND IN PERSON

Your Company has recognized the concept that service to the public must be considered a total company involvement rather than the fragmented efforts of individual departments. To accomplish this, all functions relating to the passenger—from the time an inquiry is made to our reservation office until the passenger leaves the terminal after his flight—have been placed under the responsibility of one division, Customer Services. This department is now responsible for reservations, inflight service (including stewardesses and cabin service) and all ground functions including airport personnel.

To provide for our expected growth, your Company is expanding its reservations capabilities. An agreement has been entered into with an independent computer services company to provide a modern Passenger-Name-Record reservations system which delivers, in addition, extensive marketing data for use in making management decisions. Using an independent facility instead of purchasing our own equipment assures that as computer technology increases our system will be upgraded without large capital outlays by your Company. This greatly improved facility will be partially operative by mid-1970 and will provide our passengers instantaneous confirmations of reservations on Southern and more than twenty other airlines both domestic and foreign.

Emphasis has been placed on improved inflight service. Delicious, hot meals are now being served on many longer flights. On shorter trips, our passengers are offered our attractive "wine basket service", which includes a hearty sandwich, a bottle of premium wine, condiments and a New Orleans praline.

PRODUCTIVITY OF TECHNICAL SERVICES DIVISION INCREASED

The Technical Services Division is made up of your Company's Supply, Purchasing, Production Control, Inspection, Communications and the Maintenance/Engineering Departments.

Of major emphasis during 1969 was the preparation of personnel for maintenance support of the ever growing jet fleet. DC-9 hours in revenue service increased from 12,500 in 1968 to 25,700 in 1969, and they are projected to reach over 47,000 in 1970.

Accordingly, your Company has developed the capability necessary to maintain this fleet of jet aircraft which will increase to 15 in service on April 1, 1970. This has been accomplished with no overall increase in direct maintenance personnel as result of reducing the amount of maintenance expended on the Martin fleet as the activity level for this fleet decreases.

The proper maintenance of the Martin fleet has not been neglected, however. During 1969, as a result of maintenance program improvements, the average Martin engine life between overhauls was increased about 20%, while at the same time achieving a new low in engine malfunctions.

All phases of the FAA Crashworthiness Program requirements, which were due for 1969, were met through the combined efforts of Engineering and Maintenance, insuring an even higher level of operating safety for all Southern aircraft.

SOUTHERN'S PEOPLE MAKE THE DIFFERENCE

In keeping with your Company's growth, additional personnel were required to provide the force for Southern's forward thrust. At the end of 1969, your Company had 1,744 employees, 738 of whom had been with Southern for five years or more, and 341 had ten or more years of service.

During 1969 there were 166 promotions throughout your Company. Last year also saw a successful completion of a two-year contract with the stewardesses, and the continuation of a comprehensive training program for supervisory personnel. The training program, keyed to improving service and economy through the utilization of modern management techniques, provides supervisors with the management skills so necessary for directing future operations of your Company.

PILOT TRAINING PREPARES FOR NEW JET ROUTES

The Flight Operations Division established a Training and Standards Department, assuring the highest possible qualifications for our pilots. During the year, 35 captains and 47 first officers successfully completed their DC-9 jet training. Your Company now has sufficient qualified pilots not only to meet the commitments arising from operating new route authorities, but also those arising from our greatly expanded level of charter sales.

BALANCE SHEET

December 31, 1969 and 1968

ASSETS

	1969	1968
CURRENT ASSETS		
Cash	$ 4,304,163	$ 4,143,852
Certificates of deposit	—	5,534,316
Accounts receivable:		
U.S. Government:		
Transportation and public service revenue	951,361	722,581
Refundable income taxes	436,338	552,482
Trade receivables	3,781,643	3,016,283
	5,169,342	4,291,346
Maintenance and operating supplies, at average cost, less allowances for obsolesence (1969—$279,420; 1968—$282,359)	1,462,334	1,011,101
Prepaid expenses	1,581,978	773,714
Total Current Assets	12,517,817	15,754,329
INVESTMENTS AND OTHER ASSETS—at cost	63,190	47,455
PROPERTY AND EQUIPMENT—on the basis of cost—Notes A and B		
Flight equipment	25,611,105	20,568,356
Less allowances for depreciation and maintenance	5,736,717	4,610,250
	19,874,388	15,958,106
Deposits on new equipment		3,179,958
	19,874,388	19,138,064
Other property and equipment	3,206,850	2,857,605
Less allowances for depreciation	1,995,062	1,663,114
	1,211,788	1,194,491
	21,086,176	20,332,555
DEFERRED CHARGES		
Unamortized pre-operating, route extension, and development costs	985,521	730,111
Deferred lease costs	363,566	206,780
Unamortized long-term debt expense	758,421	839,899
	2,107,508	1,776,790
	$35,774,691	$37,911,129

LIABILITIES

	1969	1968
CURRENT LIABILITIES		
Accounts payable	$ 1,691,817	$ 1,321,297
Collections and withholding as agents	2,710,114	2,459,524
Salaries, wages, and vacations	1,043,222	822,166
Accrued taxes and other expenses	1,424,505	1,012,926
Air travel plan deposits	112,200	112,625
Other	155,621	145,866
Current maturities of long-term debt—Note B	1,709,239	1,821,739
Total Current Liabilities	8,846,718	7,696,143
LONG-TERM DEBT, less current maturities—Note B		
Notes payable to banks	9,763,152	12,228,237
Convertible Subordinated Debentures	12,682,000	12,682,000
	22,445,152	24,910,237
DEFERRED TAXES ON INCOME—Note C	235,000	235,000
STOCKHOLDERS' EQUITY—Note D		
Common Stock, $2 par value:		
Authorized—5,000,000 shares:		
Issued and outstanding—1,024,871 shares	2,049,742	2,049,742
Other paid-in capital	1,229,523	1,229,523
Retained earnings	968,556	1,790,484
	4,247,821	5,069,749
COMMITMENTS—Note F		
	$35,774,691	$37,911,129

See Notes to Financial Statements.

STATEMENT OF INCOME AND RETAINED EARNINGS

Years Ended December 31, 1969 and 1968

	1969	1968
OPERATING REVENUES		
Passenger	$28,050,097	$20,503,123
Mail, express, and freight	2,163,178	1,949,557
Public service revenue	3,579,639	4,038,298
Charter	3,358,146	1,934,461
Other operating revenues—net	684,448	874,839
	37,835,508	29,300,278
OPERATING EXPENSES		
Flying operations	12,659,124	9,117,641
Maintenance	6,110,720	5,121,450
Aircraft and traffic servicing	9,078,742	7,502,089
Passenger service	1,875,449	1,282,685
Promotion and sales	3,002,821	2,306,037
General and administrative	2,286,399	1,607,534
Amortization and provision for depreciation	2,395,905	1,769,762
	37,409,160	28,707,198
	426,348	593,080
OTHER DEDUCTIONS AND (INCOME)		
Interest on long-term debt—net of interest capitalized	1,719,541	1,135,812
Gain on disposal of property	—	(90,177)
Other (income), less miscellaneous deductions	15,696	(29,714)
	1,735,237	1,015,921
LOSS BEFORE INCOME TAX CREDIT	(1,308,889)	(422,841)
INCOME TAX CREDIT—Note C		
Provision for income taxes		
Current	(486,961)	(387,862)
Deferred	—	235,000
Investment credit	—	(58,997)
	(486,961)	(211,859)
NET LOSS (per share: 1969—$.80; 1968—$.21 Note G)	(821,928)	(210,982)
RETAINED EARNINGS at beginning of year, as previously reported	1,790,484	2,122,525
Adjustment of public service revenue, net of applicable income taxes	—	(121,059)
RETAINED EARNINGS at beginning of year, as restated	1,790,484	2,001,466
RETAINED EARNINGS AT END OF YEAR	$ 968,556	$ 1,790,484

See Notes to Financial Statements.

STATEMENT OF SOURCE AND APPLICATION OF FUNDS

Years Ended December 31, 1969 and 1968

	1969	1968
FUNDS PROVIDED BY		
From Income:		
Net loss	$ (821,928)	$ (210,982)
Items not requiring outlay of funds:		
Provision for depreciation	2,160,358	1,703,817
Amortization of deferred charges	377,578	233,003
Deferred taxes on income	—	235,000
	1,716,008	1,960,838
Sale of 6½% Convertible Subordinated Debentures	—	8,000,000
Refunds of equipment purchase deposits	1,793,570	—
	3,509,578	9,960,838
FUNDS APPLIED TO		
Additions to property, plant and equipment—net	4,882,370	845,744
Equipment purchase deposits—net	—	13,008
Increase in deferred charges	533,475	583,004
Decrease in long-term debt—net	2,465,085	1,239,815
Increase in investments and other assets	15,735	14,492
	7,896,665	2,696,063
Increase (decrease) in working capital	(4,387,087)	7,264,775
Working capital at beginning of year	8,058,186	793,411
Working capital at end of year	$ 3,671,099	$ 8,058,186

ACCOUNTANTS' REPORT

Board of Directors
Southern Airways, Inc.
Atlanta, Georgia

We have examined the balance sheet of Southern Airways, Inc. as of December 31, 1969, and the related statements of income and retained earnings and source and application of funds for the year then ended. Our examination was 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. We previously made a similar examination of the financial statements for the preceeding year, which have been restated for changes in unamortized debt discount as explained in Note D.

During 1969, the Company reduced the economic useful life of cylinders used in Martin 404 aircraft and decreased the provision for overhaul applicable to DC-9 engines as described in Note A to the financial statements. These changes, with which we concur, had the effect of decreasing the net loss approximately $33,000.

In our opinion, the accompanying balance sheet and statements of income and retained earnings and source and application of funds present fairly the financial position of Southern Airways, Inc. at December 31, 1969, and the results of its operations, the changes in capital, and source and application of funds for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Ernst & Ernst
ERNST & ERNST

Atlanta, Georgia
January 30, 1970, except as to Notes B and F,
as to which the date is March 10, 1970.

December 31, 1969

NOTE A—CHANGE IN LIFE OF DEPRECIABLE ASSET AND PROVISION FOR OVERHAUL.

During 1969, the Company redetermined the economic useful life of cylinders used in Martin 404 aircraft and reduced the useful life of these assets from seven years to three years. This change had the effect of increasing the provision for depreciation approximately $153,000 and increasing the net loss approximately $98,000 ($.10 per share).

The Company has consistently followed the policy of providing for DC-9 engine overhaul based on hours of service. Based upon a review of its maintenance program applicable to DC-9 engines, the Company reduced the rate from $12.50 per hour to $7.50 per hour effective January, 1969. This change had the effect of reducing the provision for maintenance approximately $205,000 and decreasing the net loss approximately $131,000 ($.13 per share).

NOTE B—LONG-TERM DEBT.

Long-term debt at December 31, 1969, is summarized as follows:

Notes payable to banks in quarterly installments through 1976 (1) (5) (6)	$6,255,000
Note payable to banks due December 31, 1975 (1) (5) (6) (7)	3,000,000
Notes payable to banks in quarterly installments through 1974 (2) (5) (6)	2,217,391
5-3/4% Convertible Subordinated Debentures due December 1, 1981 (3) (6)	4,682,000
6-1/2% Convertible Subordinated Debentures with warrants attached due November 1, 1983 (4) (6)	8,000,000
	24,154,391
Less current maturities	1,709,239
	$22,445,152

(1) The interest rate is 1/4 of 1% above the lead bank's prime rate.

(2) The interest rate is 1/2 of 1% above the lead bank's prime rate.

(3) The 5-3/4% Convertible Subordinated Debentures due December 1, 1981 are convertible (until maturity or prior redemption) into Common Stock at $16 per share; are subordinated, generally, to all existing and future indebtedness for borrowed money; are callable at premiums ranging from 5.75% downward; and require annual sinking fund payments beginning December 1, 1976, in an amount equal to 10% of the principal amount outstanding at December 1, 1975. Also, the Company may make additional voluntary sinking fund payments equal to the required amount.

(4) The 6-1/2% Convertible Subordinated Debentures due November 1,1983, are convertible (until maturity or prior redemption) into Common Stock at $16 per share, are issued in integral multiples of $1,000 with a warrant for the purchase of 18 shares at $16 a share attached; are subordinated, generally, to all existing and future indebtedness for borrowed money; are callable on or after November 1, 1973, at premiums ranging from 6.5% downward; and require annual prepayments beginning November 1, 1978, in an amount equal to 10% of the principal amount outstanding at November 1, 1977 less credit for principal amount converted or called subsequent to November 1, 1977. Also, the Company may make additional voluntary prepayments equal to the required amount.

(5) All aircraft, engines, and related equipment are pledged as collateral on this indebtedness.

(6) The agreements relating to the notes payable and the Convertible Subordinated Debentures place certain requirements and restrictions upon, among other things, (1) net current assets, (2) indebtedness and lease obligations, (3) net worth, (4) capital expenditures, and (5) payments relating to capital stock including dividends. The Company met all of these requirements on December 31, 1969, and retained earnings is restricted from payments relating to capital stock and dividends.

(7) Prepayments are required equal to 25% of the first $1,000,000 of net income of the Company, plus 35% of the net income in excess of $1,000,000 for the twelve month period ending the preceding December 31.

(8) In order to provide for the heavy expenditures required in the early months of 1970 in connection with inaugurating service under its new route authorities, the Company obtained in January 1970 an amendment of its agreements with creditor Banks providing for the deferral of a $325,000 note payment originally due on February 1, 1970. On February 5, the agreements were also amended to, among other things, increase the aggregate amount of indebtedness (as defined) and lease obligations which may be maintained by the Company to 160% of net worth (as defined) for the period ending March 31, 1970, and thereafter to 120% of net worth. One of the major factors in the computation of such ratio is the amount of net worth of the Company. As the result of the start-up expenses mentioned previously, among other things, the Company incurred substantial losses (unaudited) during January and February 1970, and, had the Company been required at February 28, 1970 to meet this debt to net worth ratio of 120% which is presently not required until after March 31, 1970, it would have been necessary for it to have raised $613,000 from the issuance of a guaranteed note, raised $926,000 from the issuance of its equity securities, and to have used such proceeds together with $1,566,000 of cash on hand to retire an equivalent amount of indebtedness. The Company expects to obtain an amendment extending beyond March 31 the requirements of the Agreement pertaining to the ratio of indebtedness to net worth.

Under the February 5 Agreement, the Company is required to comply by January 31, 1971 with all of the conditions, terms, and covenants contained in the agreements with the Banks in effect prior to the February 5 Agreement. The Company may be able to meet such requirements through earnings generated from operations. However, if the Company is not successful in obtaining such earnings or in obtaining a further amendment of its Agreement, it is required to obtain by January 31, 1971, cash proceeds from a sale (pursuant to, on or prior to November 30, 1970 a filing with the Securities and Exchange Commission or the receipt by the creditor Banks of a written commitment for a private placement) of its equity securities sufficient to enable it to comply with the terms of such agreements in effect prior to February 5, 1970 (including the debt to net worth ratio of 120%).

NOTE C—INCOME TAXES.

The loss to be carried back for income tax purposes will exceed the loss shown in the Income Statement because of certain expenses deferred for financial statements and additional depreciation to be claimed for income tax purposes. Depreciation for financial statements is computed on the straight line method, but certain assets are depreciated on accelerated methods for income tax purposes. Because of the aforementioned differences in treatment of certain items for income tax purposes, there is a net operating loss carry forward to future years for income tax purposes of approximately $1,025,000 at December 31, 1969.

The Company uses the flow-through method of accounting for investment credit and the available investment credit is recognized to the extent that it can be realized or offset against current or deferred income taxes. Investment credit realized as a reduction of deferred income taxes amounted to approximately $207,000 at December 31, 1969.

Investment credit carry-over at December 31, 1969, for use in offsetting federal income taxes in future income tax returns amounted to approximately $1,220,000 and expires in 1976 ($65,000), 1977 ($810,000), 1978 ($37,000) and 1979 ($308,000).

NOTE D—COMMON STOCK AND OTHER PAID-IN CAPITAL.

In accordance with current accounting principles applicable to debt issued with stock purchase warrants, the Company recognized retroactively to December 31, 1968, debt discount attributable to the stock purchase warrants attached to 6-1/2% Covertible Subordinated Debentures issued in 1968. This had the effect of increasing Unamortized Long-Term Debt Discount and Other Paid-In Capital by $432,000. The Discount is being amortized over the remaining term of the indebtedness.

In May 1969, the charter of the Company was amended to increase the authorized capital of the Company from 2,000,000 shares of $2 par value Common Stock to 5,000,000 shares of $2 par value Common Stock.

These changes constitute the only changes in Common Stock and Other Paid-In Capital for the two years ended December 31, 1969.

At December 31, 1969, 1,006,625 shares of Common Stock of the Company were reserved as follows:

	Shares Reserved
Qualified Stock Option Plan approved by Board of Directors in 1965:	
Currently exercisable at a price of $10.16-2/3 per share	33,750
Exercisable one-third each year beginning in 1969 at a price of $19.18 per share	1,000
Exercisable one-third each year beginning in 1970 at a price of $13.75 per share	900
Exercisable one-third each year beginning in 1971 at prices ranging from $8.69 to $11.76 per share	7,100
Shares available for additional options which may be granted under the Plan	2,250
	45,000
Employee Stock Option Plan approved by Board of Directors in 1967:	
Exercisable in June 1970 at a price of $11.52 per share	1,833
Shares available for additional options which may be granted under the Plan	23,167
	25,000
Shares reserved for conversion of 5-3/4% Convertible Subordinated Debentures	292,625
Shares reserved for conversion of 6-1/2% Convertible Subordinated Debentures	500,000
Shares reserved for sale pursuant to stock purchase warrants issued with 6-1/2% Convertible Subordinated Debentures at a price of $16 per share	144,000
TOTAL	1,006,625

NOTE E—PENSION PLANS.

The Company has several pension plans covering substantially all of its employees. The total pension expense for the year was $774,638 which included $304,758 under a defined-contribution plan. The Company's policy is to fund normal cost plus accrued interest on the unfunded past service liability. At December 31, 1969, the total of the pension fund exceeded the actuarially computed value of vested benefits and the unfunded past service liability was approximately $519,000.

NOTE F—COMMITMENTS AND CONTINGENCIES

At December 31, 1969, the Company was leasing five DC-9 jet aircraft under leases expiring in 1980 and 1981, at a minimum annual rental of $2,032,000; three DC-9 jet aircraft under six month leases, which assuming the aircraft are retained for a full year, would result in rentals of $1,231,250 in 1970; and a communications system lease expiring in 1977 with a minimum rental of $79,000. In February, 1970 an additional three DC-9 jet aircraft were leased under six months leases which committed the Company to minimum rentals of $630,000.

Certain unsuccessful applicants for Chicago, St. Louis, and Miami operating authority have sought review in the U.S. Court of Appeals, District of Columbia Circuit, of those awards to the Company by the CAB. The Company believes such applicants' cases are without merit and expects favorable decisions before the end of 1970.

NOTE G—LOSS PER SHARE.

Loss per share of Common Stock was computed by dividing the net loss by the number of shares of Common Stock outstanding during the year. Conversion of debentures and exercise of warrants would not have increased the loss per common share.

EXECUTIVE COMMITTEE

FRANK W. HULSE
G. GUNBY JORDAN
W. B. WHITE, JR.
GRAYDON HALL
ELTON B. STEPHENS

DIRECTORS

CECIL A. BEASLEY, JR.
Ballard & Beasley
Washington, D.C.

ALEXANDER J. BRUNINI
Brunini, Everett, Grantham & Quin
Vicksburg, Mississippi

GRAYDON HALL
Southern Airways, Inc.
Atlanta, Georgia

F. BARTON HARVEY, JR.
Alex. Brown & Sons
Baltimore, Maryland

FRANK W. HULSE
Southern Airways, Inc.
Birmingham, Alabama

ALTON F. IRBY, JR.
Irby-Adams-Cates Company
Atlanta, Georgia

HENRY P. JOHNSTON
Radio and Television Consultant
Birmingham, Alabama

G. GUNBY JORDAN
The Jordan Company
Columbus, Georgia

SARTAIN LANIER
Oxford Industries, Inc.
Atlanta, Georgia

R. EUGENE ORR
Orr & Company, Inc.
Jacksonville, Florida

G. FRANK PURVIS, JR.
Pan American Life Insurance Company
New Orleans, Louisiana

F. D. SCHAS
Bullington-Schas & Company
Memphis, Tennessee

ELTON B. STEPHENS
EBSCO Industries, Inc.
Birmingham, Alabama

RICHARD A. TRIPPEER
R.A. Trippeer, Inc.
Memphis, Tennessee

W. B. WHITE, JR.
Bradley, Arant, Rose & White
Birmingham, Alabama

OFFICERS

FRANK W. HULSE, President

GRAYDON HALL
Executive Vice President-
General Manager

GEORGE M. GROSS
Vice President-Associate General Mgr.

W. S. MAGILL, JR.
Senior Vice President-
Industry and Government Affairs

J. KENNETH COURTENAY
Vice President-Economic
Regulations and Secretary

RICHARD N. HARBOTTLE
Vice President-Technical Services

W. BAYNE GRUBB
Vice President-
Flight Operations

THOMAS A. WILEY, JR.
Vice President-
Sales & Marketing

JOHN J. JANISCH
Vice President-
Customer Services

A. L. MAXSON
Treasurer

RICHARD K. ROBINSON
Controller

EVERETT L. MARTIN
Assistant Vice President-
Personnel

WILLIAM E. OAKES
Assistant Vice President-
Economic Research

J. R. PRICE
Assistant Vice President-
Properties and Facilities

VICTOR C. PRUITT
Assistant Vice President-
System Planning

ARNOLD D. WINHAM
Assistant Vice President-
Sales

A. D. YAWN
Assistant Vice President

RAY W. BURDEN
Assistant Treasurer

MRS. MARY C. HAYES
Assistant Secretary

CECIL A. BEASLEY, JR.
Assistant Secretary

W. B. WHITE, JR.
Assistant Secretary

GENERAL OFFICES

Atlanta Airport
Atlanta, Georgia 30320

COUNSEL
Bradley, Arant, Rose & White
Birmingham, Alabama

Ballard & Beasley
Washington, D.C.

AUDITORS
Ernst & Ernst
Atlanta, Georgia

STOCK TRANSFER AGENT
Trust Company of Georgia
Atlanta, Georgia

ADVERTISING COUNSEL
Harris & Weinstein Associates, Inc.
Atlanta, Georgia

General Offices: Atlanta Airport
Atlanta, Georgia 30320