Southern Airways, Inc.
1976 Annual Report

Southern

About the Company

Southern Airways, Inc. is a certificated, scheduled airline, engaged in transportation of persons, property and mail. The Company serves 14 states, the District of Columbia, and the Cayman Islands in the British West Indies. Additionally, the Company operates an extensive charter business throughout the United States and into the Cayman Islands, other points into the Caribbean, Canada, Mexico, and the Bahamas.

Southern began scheduled service on June 10, 1949. During 1976 the Company's aircraft flew more than 27 million miles, serving more than three million passengers. Aircraft in service included 28 DC9 jetliners and six Martin 404 piston-engine aircraft. Today, more than 95 per cent of Southern's revenue passenger miles are generated aboard DC9s.

Incorporated in the State of Delaware, Southern is a publicly held corporation with more than 5,300 stockholders residing in 45 states and 10 foreign countries. The Company's stock is registered and traded in the NASDAQ/Over-the-Counter Market.

Southern is one of 10 "Local Service Carriers" operating in interstate commerce to serve cities of small and intermediate size as well as in major metropolitan areas. For rendering air services to small and intermediate size communities that otherwise could not sustain scheduled service, Southern receives public service revenue (subsidy) from the Federal Government.

On the longer haul, more densely traveled routes where Southern competes with larger Trunk Carriers, the Company does not receive a subsidy. Southern's fares and quality of service are competitive.

Southern is headquartered at Hartsfield Atlanta International Airport where the Company's Maintenance Base, Reservations Center, Training Center and General Offices are located.

Market Price of Common Stock

Range of high and low bid and asked prices for the Company's Common Stock:

Year	Bid Prices High	Bid Prices Low	Asked Prices High	Asked Prices Low
1975				
First Quarter	3¾	2¾	4⅛	3⅛
Second Quarter	3½	3	3⅞	3⅜
Third Quarter	3½	2⅞	3⅞	3¼
Fourth Quarter	3⅛	2⅝	3½	3
1976				
First Quarter	5¾	3	6⅛	3⅜
Second Quarter	5½	4⅞	5⅞	5¼
Third Quarter	6¾	5¼	7⅛	5⅝
Fourth Quarter	5¼	3⅞	5⅝	4¼
1977				
First Quarter through March 18	4⅛	3¾	4½	4⅛

The foregoing prices do not represent actual transactions. They represent prices between dealers and do not include retail markup, markdown or commission. There have been no active markets in the Company's convertible preferred stock, convertible subordinated debentures, or warrants.

About the cover: Memphis, Tennessee, where Southern operates 46 flights daily and links the Southeast with Chicago, Illinois, and St. Louis, Missouri.

Highlights

SOUTHERN AIRWAYS, INC.

Years ended December 31	1976	1975	Per Cent Increase (Decrease)
PASSENGER REVENUES	**$115,206,000**	$ 95,666,000	20.4%
OPERATING REVENUES	**$140,167,000**	$ 117,950,000	18.8
OPERATING INCOME	**$ 2,492,000**	$ 6,076,000	(59.0)
NET INCOME	**$ 405,000**	$ 2,742,000*	(85.2)
PRIMARY EARNINGS PER SHARE	**$ .22**	$ 1.58*	(86.1)
REVENUE PER PASSENGER MILE	**$ 0.117**	$ 0.112	4.5
SCHEDULED SERVICE REVENUE PASSENGER MILES	**978,991,000**	852,547,000	14.8
AVAILABLE SEAT MILES	**1,926,166,000**	1,688,633,000	14.1
PASSENGER LOAD FACTOR	**50.8%**	50.5%	.6
REVENUE PASSENGERS CARRIED	**3,245,000**	2,935,000	10.6
REVENUE PLANE MILES FLOWN	**27,646,000**	25,534,000	8.3
NUMBER OF EMPLOYEES	**2,766**	2,519	9.8

*Includes in 1975 the final settlement of a fuel price dispute and reimbursements made under the Federal Airport Development Aid Program which increased net income by $1,999,000 ($1.13 per share). These highlights should be read in conjunction with the Financial Statements appearing elsewhere in this report.

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Southern

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(Between and among the following points: Atlanta, Tallahassee, Panama City, Eglin A.F.B., Pensacola, Tampa, Sarasota, Orlando, Gainesville, Jacksonville, Daytona Beach, Melbourne, West Palm Beach, Ft. Lauderdale, Miami and Key West)
Docket No. 29312

*As of March 21, 1977

Report To Stockholders

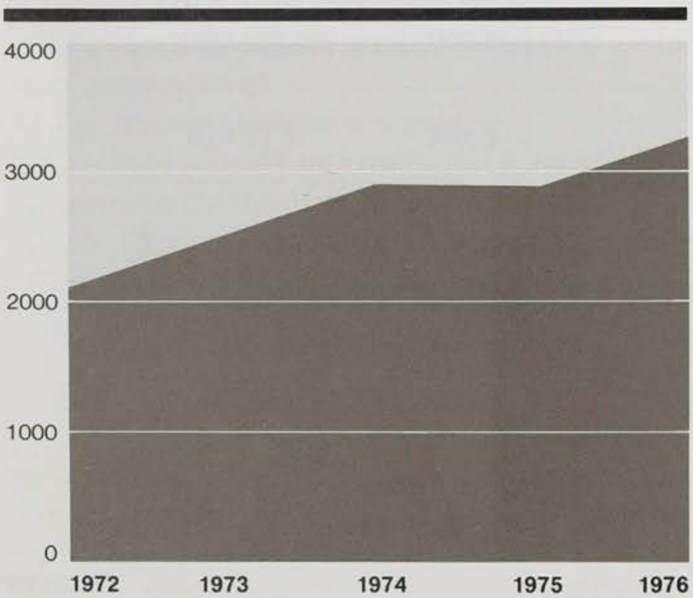
Frank W. Hulse
Graydon Hall

Calendar 1976, an encouraging year for Southern Airways despite a disappointing fourth quarter, produced record revenues, higher passenger traffic volume, and the fifth consecutive year of profitable operations. Earnings were $405,000 or 22 cents a share. Revenues totaled $140,167,000. A year earlier, earnings reached $2,742,000, equal to $1.58 per share, on revenues of $117,950,000. The 1975 earnings, however, included $1,999,000 of nonrecurring income arising from settlement of a fuel price dispute and from reimbursement of certain landing fees under the Federal Airport Development Aid Program.

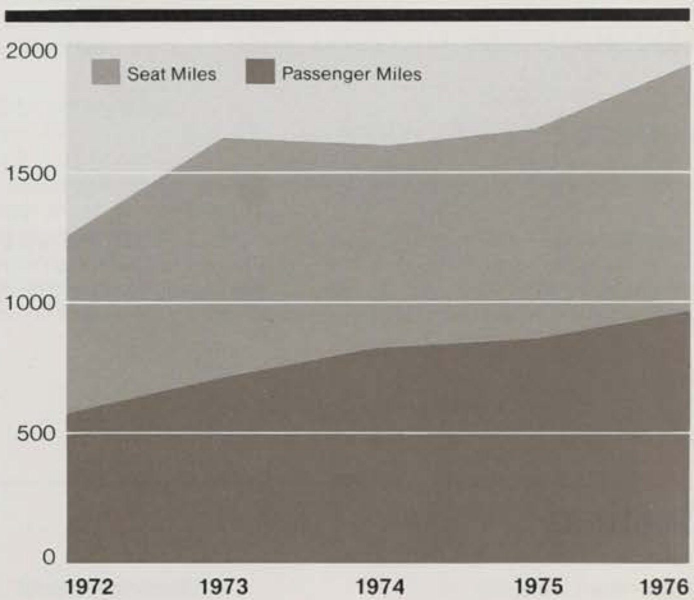
Your Company's 1976 earnings were impacted adversely by a $922,000 fourth quarter loss which resulted primarily from our passenger traffic growth rate falling to 6.1 per cent in the fourth quarter, while available seat miles increased 12.3 per cent. This mainly resulted from two DC9-30 aircraft being added to scheduled service earlier in the year.

It is gratifying to report that, since year-end, Southern's traffic has shown improvement. In January, passenger traffic increased 9.3 per cent over January 1976 despite extremely severe weather conditions. Adverse weather imposed substantial operational burdens on Southern, closed many plants in cities we serve and reduced business travel markedly. Available seat miles during the month were up 11.1 per cent. The upward trend continued in February and March with gains of 7.2 and 7.6 per cent, respectively, over

Passengers Carried
IN THOUSANDS



Available Seat Miles/Revenue Passenger Miles
IN MILLIONS



the similar months in 1976. Available seat miles were up 7.4 and 8.7 per cent, respectively, during these months.

Because of the traffic downturn in late 1976 the Company had no choice but to effect a staff reduction and to do so promptly. Some 190 persons were furloughed or terminated. Our employees at the end of February numbered 2,608, some 90 more than during the similar period last year. This growth in total personnel has resulted from increased service and a system-wide traffic gain, including expanded service between Memphis and Chicago where greater gate availability at peak traffic periods has permitted highly favorable scheduling.

Southern continues to expand its promotional efforts and to seek ever improving marketing effectiveness. As a part of this program, James G. Godsman, vice president-Sales, joined Southern in January 1976. He comes to Southern from a firm outside the airline industry where he served as marketing manager for new business ventures.

There continues to be much uncertainty as to the kind and degree of regulation to be maintained for the air transportation industry. It is obvious that some changes will be forthcoming as early as 1978. As demonstrated by our commitment to operate an additional kind of aircraft, as discussed later in this Report, we are, among other activities, positioning ourselves to minimize any problems and exploit the opportunities presented by changes in the regulatory environment.

In 1976, two members of the Board of Directors reached mandatory retirement age: Henry P. Johnston, Birmingham, Alabama, and R. Eugene Orr, Jacksonville, Florida. Each has made a long and meaningful contribution to Southern's growth. We are fortunate to have Mr. Johnston continue his association as a senior director.

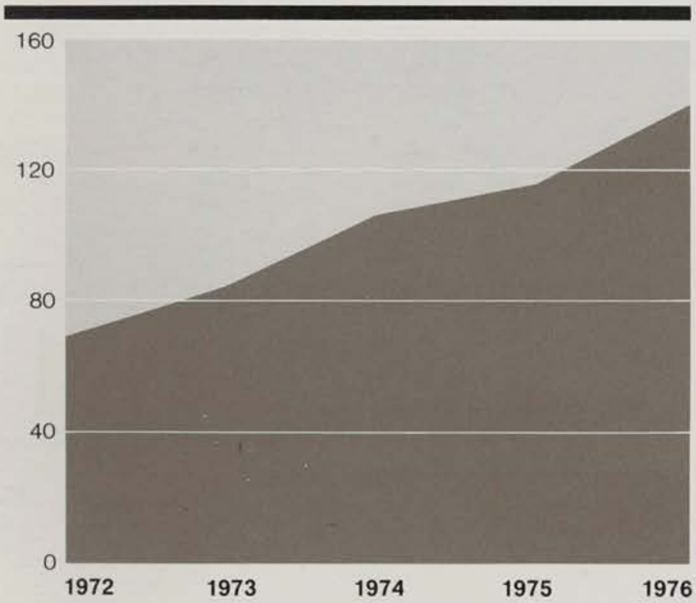
Elsewhere in this Report, you will find detailed reviews of financial results, operations, marketing expansion, new facilities, and other developments that made 1976 a year of achievement for Southern. The year 1977 justifies optimism and offers new challenges as well as opportunities. Southern is fortunate in having excellent facilities and outstanding employees to take advantage of these opportunities and to meet the challenges ahead.

Respectfully,

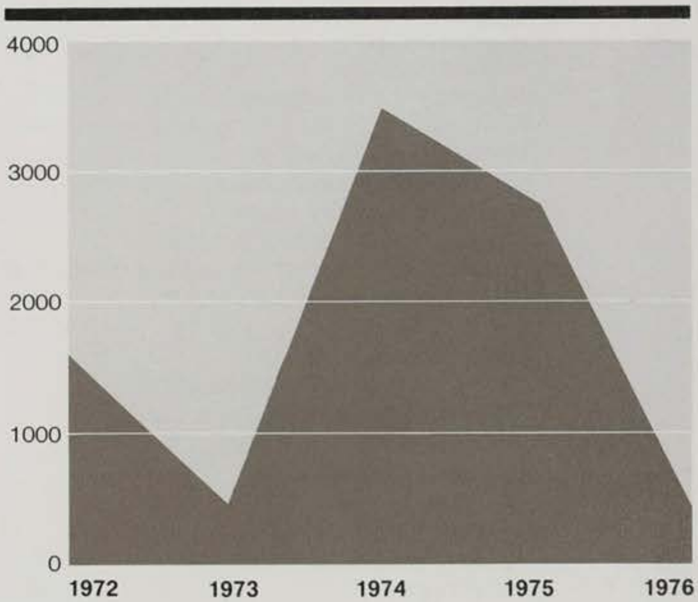
Frank W. Hulse
Chairman

Graydon Hall
President
April 1, 1977

Operating Revenues
IN MILLIONS



Net Income
IN THOUSANDS



Ten Year Operating and Financial Summary

SOUTHERN AIRWAYS, INC.

	1976	1975	1974	1973	1972	1971	1970	1969	1968	1967
Summary of Operations										
(In thousands, except per share amounts)										
Operating revenues										
Passenger	$ 115,206	$ 95,666	$ 86,821	$ 65,949	$ 52,052	$ 45,302	$ 37,187	$ 28,050	$ 20,503	$ 17,155
Charter	8,803	8,208	6,908	5,358	4,839	4,067	3,835	3,358	1,934	564
Public service	5,723	5,961	6,805	6,814	7,138	6,974	4,823	3,580	4,038	4,255
Other	10,435	8,115	7,818	6,488	5,603	4,917	4,563	3,641	3,652	2,949
	140,167	117,950	108,352	84,609	69,632	61,260	50,408	38,629	30,127	24,923
Operating expenses										
Depreciation and amortization	5,381	4,634	4,397	3,673	2,559	2,637	2,632	2,396	1,770	1,454
Other	132,294	107,240	97,072	79,447	64,180	58,216	49,556	35,807	27,764	23,537
	137,675	111,874	101,469	83,120	66,739	60,853	52,188	38,203	29,534	24,991
Operating income (loss)	2,492	6,076	6,883	1,489	2,893	407	(1,780)	426	593	(68)
Interest on long-term debt	2,468	2,918	3,929	3,083	1,362	1,678	1,789	1,720	1,136	585
Miscellaneous deductions (income) — net	(514)	(612)	(623)	(2,023)	(110)	23	(236)	15	(120)	(57)
Income (loss) before income taxes, extraordinary tax credit and accounting change	538	3,770	3,577	429	1,641	(1,294)	(3,333)	(1,309)	(423)	(596)
Income taxes (credit)	133	1,028	985	109	450	(235)	—	(487)	(212)	(358)
Income (loss) before extraordinary tax credit and accounting change	405	2,742	2,592	320	1,191	(1,059)	(3,333)	(822)	(211)	(238)
Tax benefits of net operating loss carryforward	—	—	325	97	409	—	—	—	—	—
Cumulative effect of accounting change	—	—	565	—	—	—	—	—	—	—
Net income (loss)	$ 405	$ 2,742	$ 3,482	$ 417	$ 1,600	$ (1,059)	$ (3,333)	$ (822)	$ (211)	$ (238)
Earnings (loss) per common and common equivalent share (1)										
Primary	$ .22	$ 1.58	$ 2.19	$ .23	$ 1.06	$ (1.02)	$ (3.25)	$ (.80)	$ (.21)	$ (.23)
Fully diluted	$ .22	$ 1.14	$ 1.40	$ .23	$ .80	$ (1.02)	$ (3.25)	$ (.80)	$ (.21)	$ (.23)
Average number of common and common equivalent shares										
Primary	1,581	1,765	1,599	1,314	1,440	1,035	1,025	1,025	1,025	1,025
Fully diluted	1,581	2,912	2,913	1,314	3,099	1,035	1,025	1,025	1,025	1,025
Financial Position — at year end										
(In thousands, except per share amounts)										
Current assets	$ 28,306	$ 30,324	$ 27,214	$ 25,793	$ 15,923	$ 14,336	$ 12,380	$ 12,308	$ 15,754	$ 7,048
Current liabilities	25,447	24,366	23,620	21,629	10,399	10,944	12,012	8,707	7,696	6,255
Property and equipment — net	40,651	34,818	36,414	36,467	16,987	18,739	20,336	21,086	20,333	21,178
Long-term debt (excluding current maturities)										
Notes payable and other	21,545	19,006	22,687	27,523	9,238	8,535	9,408	9,903	12,228	13,468
Convertible subordinated debentures	9,307	9,743	10,178	10,178	11,345	12,682	12,682	12,682	12,682	4,682
Total stockholders' equity	13,246	12,900	10,277	7,043	5,514	2,493	915	4,248	5,070	4,849
Common stockholders' equity (2)	12,204	11,858	9,171	4,803	3,245	(30)	915	4,248	5,070	4,849
Common stockholders' equity per common share	7.72	7.50	5.80	3.40	2.55	(.03)	.89	4.14	4.95	4.73
Common shares outstanding	1,581	1,581	1,580	1,413	1,271	1,062	1,025	1,025	1,025	1,025
Operating Statistics										
Scheduled service										
Passengers carried (thousands)	3,245	2,935	2,940	2,494	2,101	1,875	1,589	1,377	1,271	1,180
Available seat miles (thousands)	1,926,166	1,688,633	1,618,776	1,643,569	1,279,175	1,222,289	1,111,287	763,748	554,516	483,644
Revenue passenger miles (thousands)	978,991	852,547	832,372	721,135	596,197	527,552	430,736	323,472	254,028	222,142
Passenger load factor	50.8%	50.5%	51.4%	43.9%	46.6%	43.2%	38.8%	42.4%	45.8%	45.9%
Breakeven passenger load factor	50.6%	48.2%	49.0%	45.1%	44.9%	44.6%	42.9%	44.8%	47.1%	48.1%
Revenue per passenger	$ 35.46	$ 32.55	$ 29.49	$ 26.41	$ 24.73	$ 24.11	$ 23.36	$ 20.33	$ 16.08	$ 14.49
Revenue per passenger mile	11.7¢	11.2¢	10.4¢	9.1¢	8.7¢	8.6¢	8.6¢	8.7¢	8.1¢	7.7¢
All services										
Available seat miles (thousands)	2,167,198	1,906,443	1,803,177	1,798,409	1,418,799	1,336,982	1,228,373	862,388	611,795	498,322
Cost per seat mile	6.4¢	6.0¢	5.8¢	4.6¢	4.7¢	4.6¢	4.3¢	4.5¢	4.9¢	5.0¢
Number of employees at year end	2,766	2,519	2,639	2,478	2,084	1,994	1,757	1,747	1,538	1,499

(1) Primary earnings per share include $.20 (1974), $.08 (1973) and $.29 (1972) applicable to tax benefits of net operating loss carryforward and $.35 (1974) applicable to cumulative effect of accounting change. Fully diluted earnings per share include $.11 (1974), $.08 (1973) and $.20 (1972) applicable to tax benefits of net operating loss carryforward and $.19 (1974) applicable to cumulative effect of accounting change.

(2) After deducting equity of preferred shareholders at $6 per outstanding preferred share plus cumulative dividends at the end of each of the years 1971 (year preferred shares were first issued) through 1976.

Dividends on common stock of $.16 per share were paid in 1967. No cash dividends on common stock have been paid since 1967. Annual dividends of $.36 per share have been paid on preferred shares for 1972 through 1976.

Management's Discussion of 1976 and 1975 Summary of Operations

Overview

Net income in the 1974 to 1976 period was subjected to substantial variations, resulting from sudden and dramatic shifts in the rate of passenger growth during the period, substantial cost increases, and several nonrecurring events. Earnings for the period totaled $405,000 or 22 cents per share in 1976; $2,742,000 or $1.58 per share in 1975; and $3,482,000 or $2.19 per share in 1974.

Passenger traffic volume in 1975 began that year below comparable 1974 levels. The comparison was distorted because of the unusual bulge in early 1974 air travel caused by the automotive gasoline shortage. In late 1975, the rate of traffic growth rose dramatically and this continued into early 1976. In the latter half of 1976, the rate of traffic growth again shifted downward and it has continued at more moderate levels.

Anticipating a higher and more sustained level of traffic growth, Southern added aircraft in late 1975 and mid-1976. The additional aircraft met the higher traffic demand in early 1976, but with the downturn in rate of traffic growth in the second half of 1976, these added aircraft resulted in excess capacity relative to traffic demand and operating costs disproportionate to revenues generated. Consequently, a $1,327,000 profit in the first nine months of 1976 was reduced by a $922,000 fourth-quarter loss.

Extensive cost cutting measures were implemented early in 1977 to lower costs to the current level of traffic growth. As part of this program, the number of employees was reduced by 190, approximately 7 per cent of the total work force, but remained at a level above that at the end of 1975.

Continuing operating cost increases also have squeezed net income that already was under pressure from lower than expected revenues. Fuel costs have continued to rise markedly, while other cost increases have kept pace with inflation. Fare increases in 1976 did not sufficiently improve the yield necessary to offset the increased costs.

Earnings were influenced in 1975 by several nonrecurring events. A $2,074,000 settlement of a fuel price dispute, and a $595,000 reimbursement of certain landing fees, had a combined favorable effect amounting to $1,999,000 on 1975 after-tax earnings.

In both 1975 and 1976, long-term debt was reduced. These reductions together with lower prime interest rates resulted in reduced interest expense. These interest reductions, which partially offset the declines in operating income, amounted to $450,000 in 1976 and $1,011,000 in 1975.

Operating Revenues

Total operating revenues reached record levels of $140,167,000 in 1976 and $117,950,000 in 1975, up 18.8 per cent and 8.9 per cent, respectively, compared with prior years. Changes in the percentage composition of revenues is highlighted by Table 1, Revenue Composition.

Table 1 — Revenue Composition
PER CENT OF TOTAL REVENUES

	1976	1975	1974
Passenger:			
Scheduled Service	82.1%	81.1%	80.1%
Charter	6.3	7.0	6.4
	88.4	88.1	86.5
Mail, Freight and Express	4.9	4.5	4.7
Public Service	4.1	5.1	6.3
Other	2.6	2.3	2.5
	100.0%	100.0%	100.0%

Passenger revenues of $115,206,000 in 1976 represented a 20.4 per cent gain over the prior year, while the $95,666,000 in passenger revenues in 1975 reflected a 10.2 per cent gain over 1974.

Traffic behavior since 1974 is indicated by Table 2, which reflects total revenue passenger miles by quarter and the increase or decrease in revenue passenger miles over the same quarter of the prior year. As demonstrated by Table 2, Southern experienced soft traffic during the first half of 1975, which was more than offset by increased traffic levels during the second half of that year as the economy improved. The traffic recovery continued into 1976 with revenue passenger miles up 19.7 per cent in the first half of 1976 compared with the similar period in 1975.

Table 2 — Traffic Behavior By Quarter
IN MILLIONS OF REVENUE PASSENGER MILES

	1976		1975		1974
	Total RPMs	Net Change	Total RPMs	Net Change	Total RPMs
First Quarter	224	+ 37	187	− 9	196
Second Quarter	253	+ 42	211	− 9	220
Third Quarter	257	+ 33	224	+ 4	220
Fourth Quarter	245	+ 14	231	+35	196
	979	+126	853	+21	832

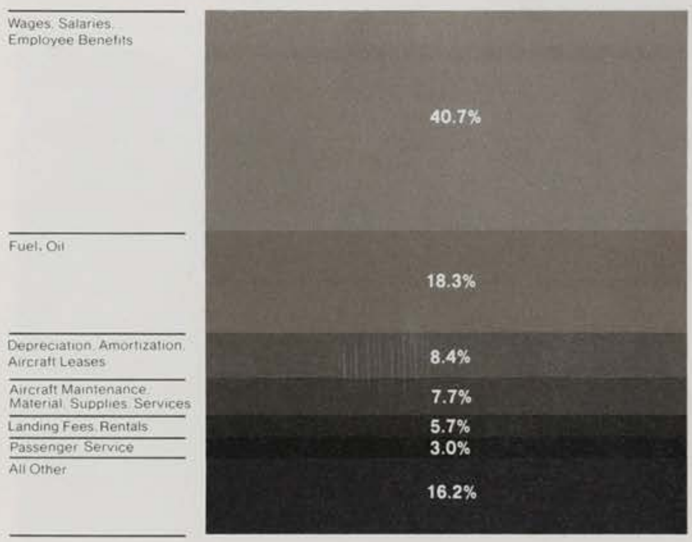
With the traffic recovery in the second half of 1975 and further increases expected in 1976, three 100-passenger DC9 (30 Series) aircraft were added to the fleet; one each in October 1975, December 1975 and August 1976. An additional 100-passenger DC9 (30 Series) aircraft was placed into service in June 1976 to replace a 75-passenger DC9 (10 Series) which was returned to a lessor. This added capacity increased available seat miles (all services) by 13.7 per cent in 1976 following a 5.7 per cent increase in 1975.

In the second half of 1976, the rate of traffic growth declined significantly. The third quarter rate of increase declined to 15 per cent and the fourth quarter produced only a 6 per cent gain over the preceding 1975 quarter.

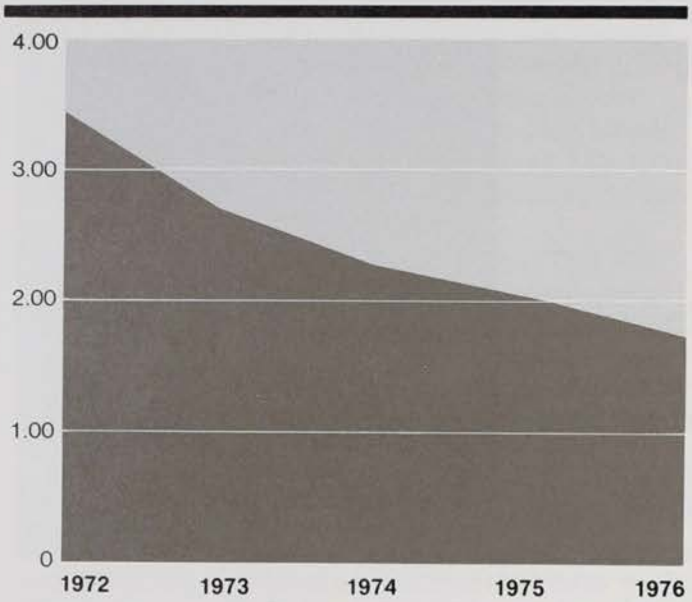
The decrease in traffic growth in the latter half of 1976 can be attributed both to an overall slowing of the rate of growth in air transportation throughout the country and to increased activity by other carriers in the Southeast. Further, in each of the two previous years a major competitor experienced a strike during the fourth quarter.

Source of Passenger Revenue Dollar
FOR THE YEAR 1976

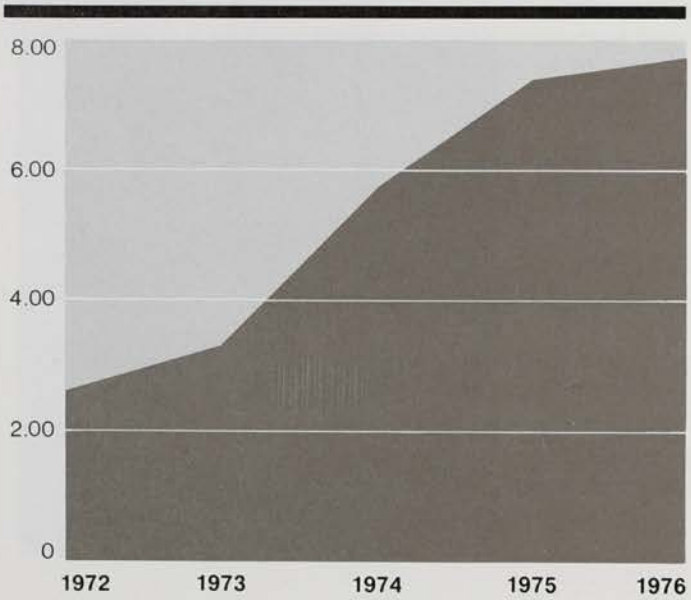
Distribution of Total Expense Dollar
FOR THE YEAR 1976



Public Service Revenue
DOLLARS PER PASSENGER



Common Stockholders' Equity
DOLLARS PER COMMON SHARE



Improved yields, i.e., revenue per passenger mile, also contributed to improvements in passenger revenues. Yield increased from 10.4 cents in 1974 to 11.2 cents in 1975 and to 11.7 cents in 1976, increases of 7.7 per cent and 4.5 per cent, respectively. These improvements reflected certain fare increases during the period, the elimination of certain discount fares, and an adjustment increasing short-haul fares resulting from the completion of an investigation of domestic passenger fares by the Civil Aeronautics Board. The latter adjustment became effective in April 1975.

Public service revenues, or government payments to the Company to provide service to certain small communities, were reduced by $238,000 in 1976, following a $844,000 reduction in 1975. In 1976 the decline resulted from reduced losses in subsidized service and the removal of certain larger cities from subsidy eligibility. The 1975 reduction was due principally to the discontinuance of service to four cities late in 1974 and to a fifth in 1975.

Operating Expenses

Operating expenses increased by $23,132,000 in 1976, following a $13,074,000 increase in 1975, exclusive of the fuel price settlement and landing fee rebate totaling $2,669,000. Of these amounts, increases of $3,117,000 and $4,119,000 in 1976 and 1975, respectively, are attributable to increases in the unit price of fuel. Increased fuel consumption as a result of increases in the number of aircraft flown on the system resulted in further cost increases of $1,777,000 in 1976 and $419,000 in 1975.

On a unit cost basis, operating expenses per available seat mile increased to 6.35 cents in 1976, up from 6.01 cents in 1975 (before reduction for the fuel price settlement and landing fee rebate) and 5.64 cents in 1974. The influence of fuel on these unit cost increases is demonstrated by Table 3, Unit Cost Analysis.

Table 3 — Unit Cost Analysis
PER AVAILABLE SEAT MILE (ASM)

	1976		1975		1974
	Cost Per ASM	% Increase	Cost Per ASM	% Increase	Cost Per ASM
Operating Expenses					
Fuel	1.18¢	9.3%	1.08¢	16.1%	.93¢
Fuel Price Adjustment and Landing Fee Rebate	—	—	(.14)	—	—
Other Operating Expenses	5.17	4.9	4.93	4.7	4.71
Total Operating Expenses	6.35	8.2	5.87	4.1	5.64
Non-Operating Charges and Credits—Net	.10		.18		.19
Total Cost	6.45¢		6.05¢		5.83¢

Labor costs, exclusive of pension expense, increased by $8,578,000 in 1976 and by $3,817,000 in 1975, primarily as a result of increased salaries and benefits. Labor costs also were affected by an increase of 9 per cent in the average number of employees in 1976, following a 4 per cent decrease in the average number of employees in 1975.

Pension expense increased $872,000 in 1976 to a total of $3,251,000, after a $480,000 increase in 1975. As a result, pension expense has climbed, from 4.4 per cent of total labor cost in 1974, to 5.0 per cent in 1975, and to 5.7 per cent in 1976. These increases were caused principally by an increased number of employees participating in the plans and by the cost of benefit improvements. Also contributing to the increases were contributions of $273,000 in 1976 and $43,000 in 1975 for the Employee Stock Ownership Plan (ESOP) adopted effective November 1, 1975.

Rental expense increased to $11,229,000 in 1976, $1,628,000 above the 1975 level. Rental expense in 1975 increased $1,669,000 over 1974. Of these amounts, aircraft rentals increased by $570,000 in 1976, following a $942,000 increase in 1975. These increases were brought about by the short-term lease of an aircraft from late 1974 through June 1976, and by the two aircraft acquired in 1975, both of which were leased under long-term agreements. The remaining increases, $1,063,000 in 1976 and $728,000 in 1975, related to property other than aircraft, principally terminal rentals. In addition to a continual program to modernize and expand these other leased properties, as required, the Company also is subject to periodic rental increases when leases are renewed or renegotiated, due principally to the inflationary rise in the cost of lessor-provided maintenance and operations. The rentals were further increased by the commencement of rentals on the new Atlanta training facility, effective October 1, 1975, and maintenance base, effective October 1, 1976.

Depreciation and amortization expense was $5,381,000 in 1976 and $4,634,000 in 1975. The increase in 1976 of $747,000 was due primarily to depreciation on the two aircraft acquired in 1976, both of which were purchased. This followed an increase of $237,000 in 1975 which resulted from the effect (approximately $330,000) of certain adjustments to the lives of DC9 rotable parts.

Advertising costs were increased by $794,000 in 1976 as a result of the need to promote new services and to initiate several new sales programs. This followed a decline in advertising costs in 1975 of $271,000 a result of the cost reduction program in effect during the first half of that year.

Increases in other operating costs, such as outside goods and services, commissions, etc, are generally reflective of the expanded operating levels and inflationary pressures.

Review of Operations

Southern's growth and facilities modernization program continued forward in 1976. An additional 238 million available seat miles were offered in scheduled service along existing routes, made possible by the acquisition in late 1975 and early 1976 of three additional DC9-30 aircraft. A new Maintenance Base was completed and occupied, a new Training Center, completed in late 1975, achieved a high degree of utilization, and a new Reservations Center and General Offices building is well underway.

Among the 63 certificated cities on Southern's system, 56 now are served with jet flights, producing 96.6 per cent of total revenue passenger miles. Each day in 1976 some 9,000 passenger-customers traveled an average 302-mile flight. On these same flights, some 23,000 ton miles of cargo and mail also were transported.

In support of this level of service, reservations agents answered an average total of 12,500 telephone calls each day. Calls from throughout the United States are answered in the Consolidated Reservations Center in Atlanta.

Southern uses a highly efficient reservations computer which contains schedules of more than 25 airlines, with Southern's schedules correspondingly logged in those carriers' reservations systems.

Each day, connections are made with every scheduled airline in the continental United States, as well as with foreign carriers at major gateways in the eastern-half of the country.

New Route Applications and Awards

Southern continues to press for profitable new markets through new route applications before the Civil Aeronautics Board. These are outlined inside the front cover of this Report. Both business-oriented and pleasure-oriented market routes are being sought.

In mid-1976, permanent authority was received as the United States Flag Carrier to the Cayman Islands in the British West Indies. Some two years earlier, temporary operating authority had been granted by the Board, until hearings could be completed and a final decision made. Since service to the Cayman Islands began, an outstanding quality of service has been provided between Miami, Florida, and Grand Cayman, the largest of the three-island chain. Daily, round trip flights have been offered, as well as many charter flights.

The experience gained in promoting and operating Cayman Islands service has led to interests elsewhere south of the United States. Three vacation destinations in Mexico — Merida, Cozumel, and Punta Cancun —

Reservations agents answer 12,500 calls daily, while Southern serves some 9,000 passengers during that time. Comfortable facilities for improved passenger service are being developed throughout Southern's system. New passenger boarding areas and modern ticket counters depict Southern's commitment to the public. In Atlanta, a new Reservations Center and General Offices building is underway to provide better support services.

Southern's new Maintenance Base and Training Center in Atlanta now are operative. Nearby, the Reservations Center and General Offices structure will be occupied late in 1977. Throughout its system, Southern is modernizing facilities and developing outstanding personnel.

were applied for in 1976. Southern proposes to serve these developing resort areas from New Orleans, Louisiana.

In the meantime, charter activities into the Bahamas, to the Caribbean, and into Mexico have been increased, further evidencing ability to promote and serve primarily vacation areas.

Business-related travel, however, always has been the Company's principal revenue source, amounting to almost 60 per cent of 1976 passenger revenues. Accordingly, Southern has been pursuing new routes supported by the business traveler. The success in developing service between Memphis and Chicago, Memphis and St. Louis, and Nashville and Detroit is expected to favorably influence new route authorizations now pending. In addition to expansion in mid-America and into the Midwest, Southern is seeking Sun Belt growth that would add service to the Georgia coast and an extensive pattern of service between and among points in Florida, as well as non-stop service to and from Atlanta.

Service to Smaller Communities

Southern also is developing a program to ensure continued service to small and intermediate cities on its 14-state domestic route network. Although few such cities are more than one hour by surface from a major or regional airport, these cities continue to need local air service, both for passengers and for cargo. Service to these points has been provided by Southern's piston aircraft, as few of the smaller points have traffic volume sufficient to support jet service or have jet-capable airports. While there has been a lack of passenger growth, and in some areas an actual passenger decline, a need does exist for a frequent pattern of service to ensure community growth.

Recognizing this, a program has been developed to offer a viable level of air service, utilizing an aircraft capable of meeting these needs. In March 1977, Southern entered into an agreement to purchase seven new, 19-passenger Metro II turboprop aircraft from Swearingen Aviation Corporation. These aircraft cruise at speeds of almost 300 miles per hour. They will replace Southern's piston aircraft which will be phased out by the end of 1977. On the short flights, where the new aircraft will be used, travel time is comparable with that of jet aircraft. Southern will implement this revitalized short-haul service during

the third quarter of this year, with delivery of the Metro IIs beginning in June. This new aircraft program also is expected to save 2,200,000 gallons of fuel annually.

Other Sources of Revenue

Already a major factor in charter sales among scheduled airlines, additional revenue opportunities are anticipated as a result of liberalized charter regulations adopted in 1976 by the Civil Aeronautics Board. Both domestic and foreign destinations are expected to attract additional tourists who will benefit from low-cost package tours.

In addition to passenger revenue generated by Southern's jet aircraft, 600 cubic feet of space is available in the cargo compartments beneath. Three services are offered: Air Express, for items that must go on a designated flight; Air Freight, when a specific flight is not required; and Swift, a guaranteed-delivery small parcel service that moves packages weighing less than 50 pounds between ticket counters and freight terminals. Sales efforts have been expanded to develop this important additional revenue. Cargo handling equipment has been installed at major freight hubs, increasing single-item shipment weight capacity to 500 pounds.

Facility Improvements

Southern has occupied a new maintenance facility at Hartsfield Atlanta International Airport. Construction at the 50-acre site was completed in September 1976, with more than eight acres of hangar, departmental workshops and support offices under one roof. The hangar area is sufficient to simultaneously house four jet aircraft. Adjoining the main building is a jet engine test cell and allied equipment. Nearby is a modern waste treatment plant that eliminates any undesirable impact on the environment.

Built to Southern's specifications, the maintenance facility is owned by the City of Atlanta, Georgia, funded with airport revenue bonds, and leased to Southern for 30 years with a renewal option.

Prior to this move, the maintenance facility had been outgrown as a result of jet fleet expansion. In the new facility, virtually every support function necessary to operate a fleet of modern DC9 aircraft will be performed. No longer will it be necessary for the Company to contract jet engine overhaul to outside sources.

A collateral benefit of the new facility is the capability of providing contract maintenance support to other airlines and government agencies. Currently

Southern's customers are served by friendly, competent men and women.

underway is a program to offer these services to airlines throughout the world. Because of the ability to move jet aircraft quickly between continents, the efficient facility and the technical experience of Southern's personnel, contract work can be scheduled to mesh with the predetermined maintenance that supports Southern's own fleet.

Southern long has provided contract maintenance for government and corporate aircraft. This experience, backed by one of the most modern and technically efficient maintenance and overhaul centers, will make possible a greatly expanded external support program.

Further Facilities Expansion

A new Reservations Center and General Offices building will be ready for occupancy in November. Built on a site adjoining the Maintenance Base, this complex will bring all Atlanta headquarters operations into one area. Previously, portions of seven buildings at various locations on or near Hartsfield Atlanta International Airport were being used.

The new building will be leased from a private owner for 30 years with renewal options. The increased efficiency from consolidated operations and favorable rental rate, compared with present rental rates, were decisive factors in this move.

A collateral benefit of the move is the consolidation of people and functions, permitting employees to share greater knowledge of each corporate department.

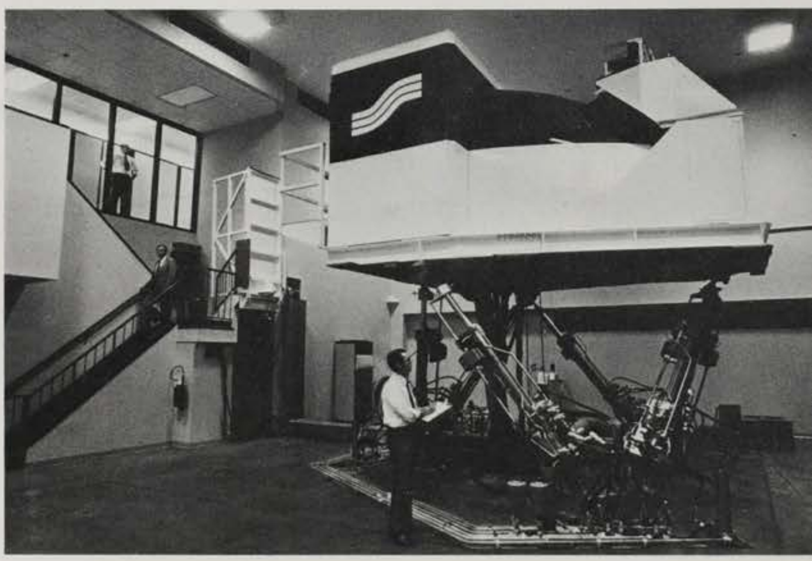
Personnel Development

Southern takes pride in the competence and high morale of its employees. Contributing to an excellent employee attitude are good working conditions, salaries in line with industry standards, excellent fringe benefits, a practice of promoting from within the Company when possible, and constant communication between employees and management.

Salaries and benefit costs represent 40.7 per cent of total expenses. As a service-oriented organization, this represents the highest operating expense category.

Furthering Company expansion and individual employee growth are new training programs. This ensures an adequate supply of qualified people to support growth. More importantly, it provides employees an opportunity to progress in the Company, in turn, increasing their capabilities and reducing turnover.

Understanding Company goals and the opportunities available to both the Company and its



Innovation extends to both training methods and promotional programs. Southern's customers constantly are reminded of the value of travel agents' free service.

Sophisticated maintenance checks determine when Southern's skilled mechanics put their experience to work.

employees is an important element in Southern's internal communications effort. Ongoing programs continue to emphasize to all personnel the necessity to earn an adequate return on investment. The employee newspaper explained this in many editions, and a filmed presentation explained and emphasized the importance of profitability and methods to be used in achieving it.

Training

Further enhancing the value of our employees is the support training offered in the new Training Center. Becoming operative late in 1975, the center was fully functional in 1976. It provides pilots with the most advanced DC9 simulator training available, as well as innovative methods for training ground personnel.

Use of the DC9 simulator permits maximum utilization of all aircraft for revenue flying and eliminates the expense of leasing simulator time from other airlines. Training schedules now may be more efficient, reducing transportation time and related expenses.

When Southern pilots are not operating the simulator, its 24-hour daily capacity permits contract use by other airlines and government agencies, making a contribution to profit. Currently, two airlines, two government agencies and a major aircraft manufacturer lease simulator time.

Flight attendants receive their initial five-week training in the center, then return for semi-annual training. New station employees receive introductory training here, before station assignments where skills are developed on the job. Classrooms in the facility often are occupied by office personnel receiving special training, or members of Southern's field sales staff learning new techniques to develop additional revenue sources.

Southern has entered into a continuing effort to improve service to its customers. The Training Center is making a significant contribution toward this goal.

Fuel Situation

Although 1976 and the first quarter of 1977 have not seen significant fuel price increases like those incurred in the 1973-1975 period, fuel costs continue to increase at an irregular rate. In the 36-month period through December 1976, jet fuel prices increased from an average of 13.9 cents per gallon in December 1973, to 32.1 cents in December 1976. At 1976 consumption levels, this equates to an annual increase of more than $14,900,000. At February 28, 1977, the average cost for jet fuel was 34.1 cents per gallon.

Elevating women to management and improving employee skills aid Southern in retaining highly qualified people.

Southern's maintenance facility utilizes eight acres of under-roof hangar and support areas.

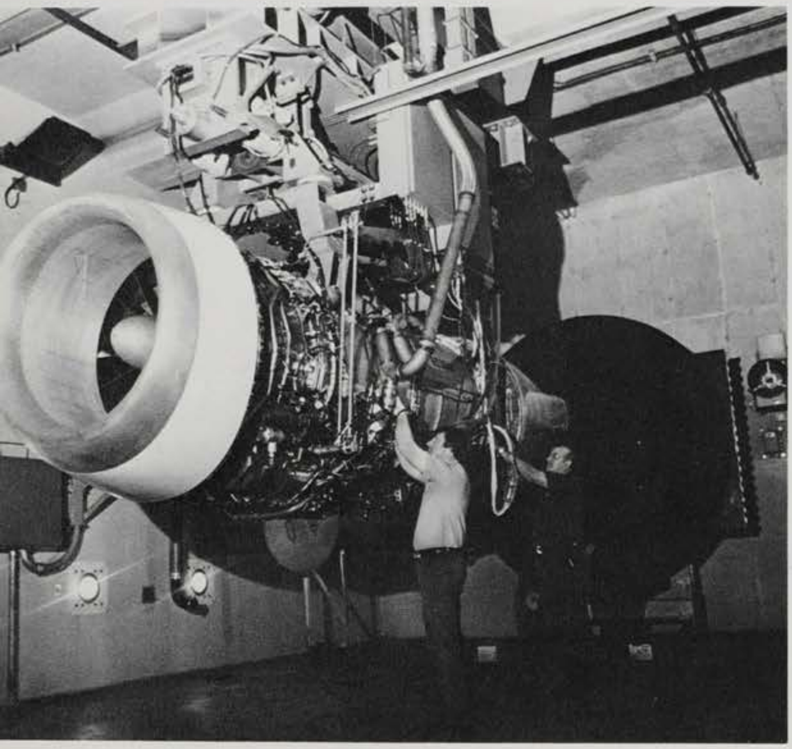
Southern has been diligent in minimizing fuel usage and the increases cited would have had an even greater adverse effect had it not been for fuel economy programs that were implemented with substantial positive results.

Southern pilots, utilizing improved flying techniques including reduced air speeds, changing some taxiing times, and modifications in refueling schedules, reduced hourly DC9 fuel burn from 944 gallons per hour to 873 gallons. This represents a savings of 71 gallons per hour and a monetary savings of more than $2 million per year.

Fuel economy programs also extend to ground equipment. Vehicles are being operated only when necessary, are shut off at all stops, and are maintained mechanically to ensure optimum mileage.

Fuel availability was not a problem through the end of 1976, but the first months of 1977 have seen some shortages. This has required some change in fueling points, but no flight schedules have required adjustment.

Additional price increase notifications have been received from major suppliers and the Company's plans for 1977 take into account anticipated jet fuel price increases.



Jet engines now are overhauled and tested in house, part of Southern's self-supporting aircraft maintenance program.

Present and Future

Southern continues to progress as a reliable and growing transportation company. Changing is the image that the Company is a small airline serving only the heartland of the Southeastern United States. Instead, the airline has won recognition in Chicago, St. Louis, Detroit, New York and Washington as a primary source of travel to and from the Southeast. Between Orlando and Miami and between Orlando and Fort Lauderdale, Southern serves more travelers than any other airline.

Elsewhere, Southern continues to provide a high level of service, always responsive to community needs.

Passenger growth will result from continued dedication to the public, both in frequency of service and in quality of service.

Underway are new programs to further increase frequency, to further upgrade quality, and to be responsive as always to Southern's primary purpose:

> *"... to provide the best in short-haul air transportation throughout the Southeast and to provide convenient long-haul service to and from other parts of the country from our key gateway cities."*

Statement of Income
SOUTHERN AIRWAYS, INC.

Year ended December 31,	1976	1975
Operating Revenues		
Passenger	$115,206,000	$ 95,666,000
Mail, express and freight	6,848,000	5,351,000
Public service revenue	5,723,000	5,961,000
Charter	8,803,000	8,208,000
Other	3,587,000	2,764,000
	140,167,000	117,950,000
Operating Expenses — Note B		
Flying operations	49,802,000	41,628,000
Maintenance	19,337,000	16,831,000
Aircraft and traffic servicing	32,804,000	26,782,000
Passenger service	8,598,000	7,490,000
Promotion and sales	12,246,000	9,012,000
General and administrative	7,633,000	6,053,000
Depreciation and amortization	5,381,000	4,634,000
Other	1,874,000	1,518,000
Fuel price adjustment (credit) — Note B	—	(2,074,000)
	137,675,000	111,874,000
Operating Income	2,492,000	6,076,000
Other Deductions and Income		
Interest on long-term debt	2,468,000	2,918,000
Gain on disposal of property	(91,000)	(40,000)
Miscellaneous deductions (income) — net	(423,000)	(572,000)
	1,954,000	2,306,000
Income Before Income Taxes	538,000	3,770,000
Income taxes — Note D	133,000	1,028,000
Net Income	$ 405,000	$ 2,742,000
Net Income per Common and Common Equivalent Share — Note I		
Primary	$ .22	$ 1.58
Fully diluted	$ .22	$ 1.14

See Notes to Financial Statements.

Balance Sheet

SOUTHERN AIRWAYS, INC.

Assets	December 31, 1976	1975
Current Assets		
Cash, including short-term investments of $3,200,000 in 1976 and $7,599,000 in 1975 — Note C	$ 8,131,000	$11,918,000
Accounts receivable		
U.S. Government — transportation and public service revenue	1,703,000	2,135,000
Trade receivables, less allowance for doubtful accounts (1976 — $162,000; 1975 — $127,000)	11,492,000	9,709,000
	13,195,000	11,844,000
Maintenance and operating supplies, at average cost less allowance for obsolescence (1976 — $1,717,000; 1975 — $1,498,000) — Note A	6,006,000	5,645,000
Prepaid expenses	974,000	917,000
Total Current Assets	28,306,000	30,324,000
Property and Equipment — on the basis of cost — Notes A and C		
Flight equipment	58,812,000	51,349,000
Other property and equipment	7,865,000	6,204,000
	66,677,000	57,553,000
Less allowances for depreciation and maintenance	26,026,000	22,735,000
	40,651,000	34,818,000
Deferred Charges and Other Assets		
Deferred charges — Note A	949,000	1,230,000
Other assets	252,000	241,000
	1,201,000	1,471,000
	$70,158,000	$66,613,000

See Notes to Financial Statements.

Liabilities and Stockholders' Equity

	December 31, 1976	1975
Current Liabilities		
Accounts payable	$ 6,264,000	$ 5,644,000
Collections and withholdings as agent	1,387,000	1,206,000
Salaries, wages and vacations	3,914,000	3,222,000
Accrued interest payable	567,000	713,000
Accrued income taxes	109,000	1,093,000
Accrued taxes and other expense	2,258,000	837,000
Air traffic liability	7,996,000	7,535,000
Current maturities of long-term debt — Note C	2,952,000	4,116,000
Total Current Liabilities	25,447,000	24,366,000
Long-Term Debt, less current maturities — Note C		
Notes payable and other	21,545,000	19,006,000
Convertible subordinated debentures	9,307,000	9,743,000
	30,852,000	28,749,000
Deferred Credits and Other Liabilities		
Deferred income taxes	391,000	496,000
Other	222,000	102,000
	613,000	598,000
Stockholders' Equity — Notes C and E		
Preferred Stock, authorized 2,000,000 shares, issuable in series:		
Series A, $.36 Convertible, $1 par value, voting (liquidation value $6 per share plus cumulative dividends — aggregate of $1,042,000) issued and outstanding — 163,781 shares	164,000	164,000
Common Stock, $2 par value, authorized 7,500,000 shares, issued and outstanding 1,580,880 shares	3,162,000	3,162,000
Other paid-in capital	5,124,000	5,124,000
Retained earnings	4,796,000	4,450,000
	13,246,000	12,900,000
Leases, Commitments and Contingencies — Notes G and H		
	$70,158,000	$66,613,000

Statement of Changes in Financial Position
SOUTHERN AIRWAYS, INC.

Year ended December 31,		1976	1975
Funds Provided			
From operations			
Net income		$ 405,000	$2,742,000
Items not requiring outlay of working capital in current period:			
Depreciation		4,878,000	4,177,000
Allowance for maintenance (deduction)		(82,000)	(2,000)
Amortization of deferred charges		396,000	388,000
Deferred credits and other liabilities		15,000	304,000
Total from operations		5,612,000	7,609,000
Issuance of long-term debt		8,918,000	—
Property and equipment sold, less gain included in operations		88,000	84,000
Recovery of hijacking payment less deferred subsidy — Note B		—	1,400,000
Reclassification of equipment to inventory		—	533,000
		14,618,000	9,626,000
Funds Used			
Additions to property and equipment		10,517,000	2,331,000
Utilization of DC9 engine maintenance reserve		200,000	665,000
Reduction of long-term debt		6,815,000	4,116,000
Dividends on preferred stock		59,000	119,000
Other		126,000	31,000
		17,717,000	7,262,000
Increase (Decrease) in Working Capital		(3,099,000)	2,364,000
Working capital at beginning of year		5,958,000	3,594,000
Working Capital at End of Year		$ 2,859,000	$5,958,000
Increase (Decrease) in Working Capital by Component			
Cash and short-term investments		$(3,787,000)	$ 23,000
Accounts receivable		1,351,000	1,870,000
Maintenance and operating supplies		361,000	1,068,000
Prepaid expenses		57,000	149,000
Accounts payable	(621,00)	(620,000)	1,626,000
Collections and withholdings as agent		(181,000)	(162,000)
Salaries, wages and vacations		(692,000)	(59,000)
Accrued interest, taxes and other expenses	296	(291,000)	(850,000)
Air traffic liability	460	(461,000)	(1,021,000)
Current maturities of long-term debt		1,164,000	(280,000)
Increase (Decrease) in Working Capital		$(3,099,000)	$2,364,000

See Notes to Financial Statements.

Statement of Stockholders' Equity

SOUTHERN AIRWAYS, INC.

Years Ended December 31, 1976 and 1975	Preferred Stock $1 Par Value Series A	Common Stock $2 Par Value	Other Paid-In Capital	Retained Earnings
Balance, January 1, 1975	$165,000	$3,160,000	$5,125,000	$1,827,000
Net income				2,742,000
Dividends on preferred stock ($.36 per share)				(119,000)
Common stock issued upon conversion of preferred stock	(1,000)	2,000	(1,000)	
Balance, December 31, 1975	164,000	3,162,000	5,124,000	4,450,000
Net income				405,000
Dividends on preferred stock ($.36 per share)				(59,000)
Balance, December 31, 1976	$164,000	$3,162,000	$5,124,000	$4,796,000

See Notes to Financial Statements.

Notes to Financial Statements

SOUTHERN AIRWAYS, INC.

December 31, 1976

Note A — Summary of Significant Accounting Policies

Property, Equipment, Depreciation and Obsolescence

Provisions for depreciation of property and equipment are computed on the straight-line method calculated to amortize the cost of the properties over their estimated useful lives. For DC9 flight equipment the life is 15 years (new equipment) and 10 years (used equipment and rotable parts), with a 10 per cent salvage value; for ground equipment, the life ranges from three to 10 years.

The Company is engaged in a program of permanently reducing the use of Martin 404 flight equipment. At December 31, 1976, the Company's investment in Martin 404 flight equipment is fully depreciated except for $394,000 related primarily to engine overhauls, which will be charged to operations based on hours flown.

At the time properties are retired, the amounts of costs and allowances for depreciation and maintenance are eliminated from the accounts. Profits and losses on disposals of DC9 flight equipment (exclusive of rotable parts) are credited or charged to operations. Proceeds from the disposal of DC9 rotable parts are credited to the allowance for depreciation account. Proceeds from the disposal of Martin 404 flight equipment and rotable parts are included in income.

Expenditures for ordinary maintenance and repairs are charged to expense. Expenditures for major spare parts are capitalized and minor parts are recorded in inventory accounts and charged to expense as used.

A provision for obsolescence of the investment in minor spare parts inventory for DC9 aircraft is made at an annual rate of 4 per cent.

Deferred Charges

Expenditures for preoperating and route extension and development costs are deferred and are amortized over a period of five years from the dates operations of the routes are started. Costs associated with obtaining leased DC9 aircraft are being amortized over the lives of the leases. Deferred charges associated with long-term debt are being amortized over the period of the financing arrangements.

Income Taxes

Income taxes are provided at current tax rates for all items included in the statement of operations regardless of the years when such items are reported for tax purposes.

The Company uses the flow-through method of accounting for investment tax credit, and available investment tax credit is recognized to the extent it can be realized or offset against income taxes currently payable or deferred.

Pension Plans

The Company has several pension plans covering substantially all of its employees. There are no unfunded past service costs. The Company's policy is to fund pension costs accrued. At December 31, 1976, the assets of the pension fund exceeded the actuarially computed value of vested benefits.

Employee Stock Ownership Plan

The Company has an Employee Stock Ownership Plan (ESOP) for certain of its employees. The Plan was established effective November 1, 1975. The Company's contributions to the plan are determined annually at rates related to the base compensation of active participants. It is the Company's policy to fund contributions accrued.

Public Service Revenue

The Company receives public service revenue from the Civil Aeronautics Board (CAB) for providing service to small and intermediate-size cities on its routes. Amounts received and recognized as revenues are those paid for the period based on the formula then in effect.

Note B — Certain Significant Transactions and Changes Affecting Operating Results

In January 1976, pursuant to an offer tendered in December 1975, the Company purchased $871,400 principal amount of 5-3/4% Convertible Subordinated Debentures at a price of $750 for each $1,000 debenture plus certain brokerage and other related expenses. A gain of $200,000 ($145,000 after income taxes — 9 cents per share) resulted from the repurchase. These debentures were used to satisfy sinking fund payments due December 1, 1976 and 1977.

In early 1974, a fuel supplier notified the Company that its contract with the Company was withdrawn and future fuel deliveries would only be made on a spot price basis. Subsequently, the Company filed an action in the Federal District Court seeking a declaration that the supplier must specifically perform under the terms of the contract, which expired May 31, 1975. In January 1976, the Company negotiated a final settlement of the amount due to the supplier under this contract. The amount provided in 1974 as due to the supplier exceeded the final settlement by $2,074,000 and such amount has been included separately in the statement of income for 1975 as a reduction of operating expenses. This final settlement had the effect of increasing net income by approximately $1,500,000 (85 cents per share).

In 1975, the City of Atlanta reimbursed airlines using Hartsfield Atlanta International Airport for certain amounts which the airlines had advanced toward airport expansion through higher landing fees since 1967. These funds were made available to the City under the Federal Airport Development Aid Program. This reimbursement of $686,000 (which includes interest of $91,000) has been included as a reduction of expenses and in interest income for 1975 and had the effect of increasing net income approximately $499,000 (28 cents per share).

In 1973, the CAB implemented a subsidy formula which recognized the $2 million ransom payment retained by the Republic of Cuba following a 1972 hijacking. This formula resulted in increased subsidy revenue; however, the Company was required to return to the CAB a proportionate amount of the increased subsidy revenue when the ransom was returned. Following receipt of approximately $2 million from the Cuban Government in 1975, representing payment in full return of the ransom funds, the Company refunded to the CAB approximately $490,000 of the $600,000 which had been deferred at December 31, 1974. General and administrative expenses were reduced by approximately $110,000 for the final subsidy settlement related to the hijacking payment. The settlement resulted in an increase in net income for 1975 of approximately $80,000 (five cents per share).

Note C — Long-Term Debt

At December 31,	1976	1975
Notes payable to banks under a Credit Agreement dated February 20, 1973 and amended February 2, 1976		
"A" Term Loans, payable quarterly through 1982	**$13,183,000**	$15,403,000
"B" Revolving Loans, payable in 1978 and 1979	**4,400,000**	7,284,000
"C" Term Loans, payable quarterly through 1984	**6,754,000**	—
Other	**160,000**	—
Convertible Subordinated Debentures		
5-3/4% due December 1, 1981	**3,474,000**	4,345,000
6-1/2% due November 1, 1983	**5,833,000**	5,833,000
	33,804,000	32,865,000
Less current maturities	**2,952,000**	4,116,000
	$30,852,000	$28,749,000

The Credit Agreement loans bear interest at the lead bank's prime rate (six per cent at December 31, 1976) plus one per cent ("A" and "C" Term Loans) and two per cent ("B" Revolving Loan) and are payable in quarterly installments. Substantially all of the Company's assets are pledged as collateral under the terms of the Credit Agreement. Additionally, the "A" and "C" Term Loans are 90 per cent guaranteed by the Federal Aviation Administration.

On February 2, 1976, the "B" Loan was converted from a term loan to a revolving credit loan under which the Company may borrow, repay and reborrow through 1978, subject to quarterly reductions in the amount of funds available. The unused "B" Loan Commitment at December 31, 1976, was $1,424,000.

In connection with the Credit Agreement, the Company maintains average compensating balances, based on bank ledger balances adjusted for treasury tax contributions and uncollected funds, equal to the sum of 15 per cent of the average daily balance of the "A" and "B" Loans outstanding, 15 per cent of the unused portion of the "B" Loan Commitment, and 20 per cent of the average daily balance of the "C" Loan outstanding. Based upon outstanding borrowings at December 31, 1976, the Company should maintain average compensating balances of approximately $4,483,000, which stated in terms of the Company's book cash balances is approximately $2,409,000. The difference is attributable to average uncollected funds and float. During 1976, the Company maintained average compensating balances of approximately $4,660,000. Compensating balances are not restricted as to withdrawals, serve in some instances as compensation to the participating banks for their account handling function and other services, and additionally serve as part of the Company's minimum operating cash balances.

The 5-3/4% Convertible Subordinated Debentures due December 1, 1981, are convertible (until maturity or prior redemption) into common stock at $10.86 per share; are subordinated, generally, to all existing and future indebtedness for borrowed money; are callable at premiums currently ranging from 1.75 per cent downward; and require annual sinking fund payments on December 1 of each year in an amount equal to $435,000. In January 1976, pursuant to an offer tendered in December 1975, the Company purchased $871,400 principal amount of the 5-3/4% Convertible Subordinated Debentures at a price of $750 for each $1,000 debenture, plus certain brokerage and other related expenses. These debentures were used to make the sinking fund payments due December 1, 1976, and December 1, 1977. Also, the Company may make additional voluntary prepayments equal to the required amounts.

The 6-1/2% Convertible Subordinated Debentures due November 1, 1983, are convertible (until maturity or prior redemption) into common stock at $10 per share; are subordinated, generally, to all existing and future indebtedness for borrowed money, are callable at premiums ranging from four per cent downward; and require annual sinking fund payments beginning November 1, 1978, in an amount equal to 10 per cent 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 amounts.

The terms of the Credit Agreement and both issues of convertible subordinated debentures place certain requirements and restrictions upon, among other things, (a) working capital, (b) indebtedness and lease obligations, (c) capital expenditures, (d) net worth and (e) payments relating to capital stock, including dividends. Retained earnings available for the payment of dividends at December 31, 1976, under the most restrictive requirement, amounted to approximately $1,885,000.

A summary of minimum principal payments under the Credit Agreement loans, other indebtedness and both issues of convertible subordinated debentures is as follows:

	Credit Agreement Loans				Convertible Subordinated	
Year	"A"	"B"	"C"	Other	Debentures	Total
1977	$ 2,220,000	$ —	$ 724,000	$ 8,000	$ —	$ 2,952,000
1978	2,220,000	1,276,000	965,000	9,000	1,015,000	5,485,000
1979	2,220,000	3,124,000	965,000	11,000	1,018,000	7,338,000
1980	2,220,000	—	965,000	13,000	1,018,000	4,216,000
1981	2,220,000	—	965,000	16,000	2,756,000	5,957,000
Thereafter	2,083,000	—	2,170,000	103,000	3,500,000	7,856,000
	$13,183,000	$4,400,000	$6,754,000	$160,000	$9,307,000	$33,804,000

A reduction in the "B" Loan Commitment is required equal to 25 per cent of net income in excess of $1,500,000 plus 50 per cent of net income in excess of $3,000,000 earned in any fiscal year. The above summary of minimum principal payments does not reflect the possible effect of any prepayment which may result from the reduction in the commitment.

Note D — Income Taxes

Income taxes are as follows:

	1976	1975
Current:		
Federal	**$361,000**	$1,309,000
State	**42,000**	155,000
Investment tax credit	**(193,000)**	(638,000)
	210,000	826,000
Deferred:		
Federal	**(122,000)**	396,000
State	**(15,000)**	33,000
Investment tax credit	**60,000**	(227,000)
	(77,000)	202,000
	$133,000	$1,028,000

Deferred income taxes resulted from timing differences in the recognition of revenue and expense for tax and financial reporting purposes. The sources of these differences and the tax effect of each were as follows:

	1976	1975
Accelerated depreciation for tax purposes	**$ 25,000**	$ 791,000
Provision for inventory obsolescence for financial reporting purposes in excess of amount allowed for tax purposes	**(51,000)**	(111,000)
Provision for maintenance	**(39,000)**	(166,000)
Deferred compensation	**(61,000)**	(43,000)
Other	**(11,000)**	(42,000)
Investment tax credit	**60,000**	(227,000)
	$ (77,000)	$ 202,000

The sum of current and deferred Federal income taxes in each year before applicable investment tax credits equals approximately 48 per cent (the statutory Federal tax rate) of income before taxes after deducting the state tax provision shown above.

Investment tax credit carryovers, which may be used to offset Federal income taxes payable in future income tax returns, aggregate approximately $927,000 and expire in 1978 ($26,000), 1979 ($44,000), 1980 ($257,000), 1981 ($126,000), 1982 ($193,000), and 1983 ($281,000). Approximately $417,000 of this amount has been utilized as a reduction of deferred taxes for financial reporting purposes.

Note E — Capital Stock and Options

The Series A Preferred Stock is convertible into common stock on a share for share basis, can be redeemed at the Company's option after July 1, 1976, at $6 per share plus accumulated dividends and is entitled upon liquidation to receive $6 per share plus accumulated dividends. The liquidation preference for the 163,781 shares outstanding at December 31, 1976, including the dividend requirement described below, aggregated $1,042,000 which is $878,000 more than the aggregate par value of such shares.

Each share of preferred stock is entitled to receive annual dividends of 36 cents cumulative only to the extent of annual net profits. Payment of dividends is also subject to the limitations prescribed by the

Indenture Agreements covering the 5-3/4% and 6-1/2% Convertible Subordinated Debentures and to limitations contained in the Credit Agreement (See Note C). The dividend requirement on preferred shares at December 31, 1976, aggregated $59,000 and was paid on February 28, 1977.

Authorized common shares include 1,560,163 shares and 1,674,403 shares reserved at December 31, 1976 and 1975, respectively, for issuance as follows:

	1976	1975
For convertible securities conversions:		
5-3/4% Convertible Subordinated Debentures (Note C)	**319,853**	400,093
6-1/2% Convertible Subordinated Debentures (Note C)	**583,300**	583,300
Series A Convertible Preferred Stock	**163,781**	163,781
	1,066,934	1,147,174
For exercise of outstanding warrants at $6 per share, issued with Convertible Preferred Stock	**457,229**	457,229
For options under Qualified Stock Option Plan (1976-11,000 shares; 1975-45,000 shares) and Employee Stock Option Plan (25,000 shares)	**36,000**	70,000
	1,560,163	1,674,403

At December 31, 1976, there were outstanding options for 11,000 shares of common stock under the Company's Qualified Stock Option Plan, of which 4,000 shares (at $5.81 per share) expire in 1978, 3,000 shares (at $3.50 per share) expire in 1979, and 4,000 shares (at $2.94 per share) expire in 1980. Option transactions during the two years ended December 31, 1976, are summarized as follows:

	Number of Shares	Option Price Per Share	Option Price Total
Outstanding January 1, 1975	44,000	$3.50-$5.81	$229,000
Granted	4,000	2.94	12,000
Expired	(3,000)	5.25- 5.81	(16,000)
Outstanding December 31, 1975	45,000	2.94- 5.81	225,000
Expired	(34,000)	5.25	(179,000)
Outstanding December 31, 1976	11,000	$2.94-$5.81	$ 46,000

The Qualified Stock Option Plan expired on October 26, 1975, except for options which were outstanding at that date.

Options granted under the Plan are intended to constitute "qualified stock options" as defined in Section 424 (b) of the Internal Revenue Code of 1954, as amended. Options are exercisable at not less than 100 per cent of the fair market value of the stock on the date of grant, terminate not later than five years after date of grant, and are not exercisable during the first 24 months after date of grant. Each option is exercisable with respect to one-third of the number of shares at any time after 24 months following date of grant, with respect to an additional one-third after 36 months, and with respect to the balance after 48 months. No options were exercised during the two years ended December 31, 1976. Options became exercisable as follows:

	1976	1975
Number of Shares	**2,333**	12,667
Option Price:		
Per Share	**$3.50-$5.81**	$5.25 -$5.81
Total	**$ 11,000**	$ 67,000
Quoted Market Price at Date Exercisable:		
Per Share	**$5.00-$5.50**	$2.875-$3.25
Total	**$ 12,000**	$ 37,000

Options for 3,667 shares (aggregating $19,000 at option prices) and 35,333 shares (aggregating $186,000 at option prices) were exercisable at December 31, 1976 and 1975, respectively.

A total of 25,000 shares of common stock are reserved for issuance to participating employees under an Employees' Stock Option Plan (an employee stock purchase plan as defined by section 423(b) of the Internal Revenue Code of 1954). This plan is currently inactive and there are no participants.

The Company makes no charge to income with respect to options.

Note F — Pension and Employee Stock Ownership Plan

Pension expense was $3,251,000 in 1976 and $2,379,000 in 1975, which includes $273,000 in 1976 and $43,000 in 1975 applicable to the Employee Stock Ownership Plan adopted in 1975. During 1976, the Company made certain changes in one of its plans to provide increased benefits, which had the effect of increasing pension costs by approximately $450,000.

The plans have been modified to comply with the Employee Retirement Income Security Act of 1974 to the extent of existing regulations.

Note G — Leases

Total rental expense for all leases amounted to:

	1976	1975
Financing leases (minimum rentals):		
Flight equipment	$ 5,933,000	$4,991,000
Other financing leases	3,299,000	2,132,000
Other leases:		
Minimum rentals	1,636,000	1,912,000
Contingent rentals	431,000	639,000
	$11,299,000	$9,674,000

Contingent rentals for 1976 and 1975 consist of charges of $331,000 and $437,000, respectively, for reservation services based upon the number of unduplicated passengers in excess of a specified minimum of $120,000 per annum; and $100,000 and $202,000, respectively, for that portion of the rental charges for a short-term leased aircraft which was based on hours flown. Rentals received from subleases are immaterial.

Future minimum rental commitments as of December 31, 1976, for all noncancelable leases including the new Maintenance Center at the Hartsfield Atlanta International Airport are as follows:

	Financing Leases				
	Flight Equipment	Maintenance Center	Other Financing Leases	Other Leases	Total
1977	$ 5,901,000	$ 2,535,000	$ 2,023,000	$ 744,000	$ 11,203,000
1978	5,901,000	2,535,000	1,741,000	544,000	10,721,000
1979	4,924,000	2,535,000	1,629,000	450,000	9,538,000
1980	2,861,000	2,535,000	1,594,000	345,000	7,335,000
1981	2,508,000	2,535,000	1,587,000	160,000	6,790,000
1982-1986	4,778,000	12,673,000	6,816,000	541,000	24,808,000
1987-1991	—	12,673,000	5,245,000	356,000	18,274,000
1992-1996	—	12,673,000	1,703,000	30,000	14,406,000
Remainder	—	22,173,000	1,300,000	16,000	23,489,000
	$26,873,000	$72,867,000	$23,638,000	$3,186,000	$126,564,000

The Maintenance Center lease extends to October 1, 2005, and may be renewed at the Company's option for an additional term extending to January 1, 2024.

Most of the Company's other leases do not contain formal renewal options. However, consistent with the prevailing practice in the industry, leases with relatively short terms are generally renegotiated and extended at the conclusion of their terms and leases with relatively long terms generally provide for renegotiation of their provisions at specified intervals throughout their term.

The estimated present values of the net fixed minimum rental commitments for all non-capitalized financing leases are:

	Interest Rates Used					
	Weighted Average		Range		As of December 31,	
	1976	1975	1976	1975	1976	1975
Flight equipment	7.98%	7.91%	5.3%- 9.2%	5.3%- 9.2%	$21,941,000	$25,977,000
Computer and message switching equipment	11.39	14.01	7.5 -23.7	7.5 -23.7	1,539,000	622,000
Airport terminal facilities	5.35	5.50	2.9 - 8.0	2.9 - 7.5	8,924,000	7,264,000
Maintenance, training and other facilities*	7.62	7.22	3.5 - 7.8	3.5 - 7.5	30,351,000	9,754,000
Miscellaneous ground equipment	7.52	6.12	7.5	5.1 - 6.8	94,000	9,000

*Includes only land and phase one facilities for new Maintenance Center in 1975.

The present values were computed after reducing total rental commitments, where required, by estimated or actual amounts applicable to lessors' payments of taxes, insurance, maintenance, and other operating expenses.

If all financing leases had been capitalized and it was assumed that the estimated present values were amortized on a straight-line method over the terms of the leases and that interest expense was accrued on the outstanding lease obligations at the rates shown above, the increase in expenses would have been as follows:

	1976	1975
Rent expense — net	**$(8,619,000)**	$(6,659,000)
Amortization of leased property	**5,505,000**	4,586,000
Interest expense	**3,597,000**	2,394,000
Income taxes	**(121,000)**	(90,000)
	$ 362,000	$ 231,000

To the extent that the increased expenses were not offset by resultant increases in subsidy revenues and related income taxes, which are indeterminable as to specific amounts, net income would have been decreased.

Landing fees were $3,094,000 in 1976; and $1,950,000 in 1975, after reduction for the reimbursement by the City of Atlanta of $595,000 (see Note B).

Note H — Other Commitments and Contingencies

In connection with the sale of two aircraft in 1973, the Company agreed to indemnify the purchaser against loss to the extent of $350,000 in the event the third party to which the purchaser resold the aircraft should default in payment to the purchaser.

The Company has an employment agreement with its Chairman of the Board providing for his employment to December 31, 1979, at an annual salary of not less than $90,000. In addition, upon his retirement, the Company has agreed to pay $4,000 per month to him for life, or not less than 180 months to him and his lineal descendants in the event of his death. Provision for the amount due under the retirement agreement is being made over a five-year period beginning in 1975.

The Company is the defendant in a number of law suits. In the opinion of management there is adequate insurance coverage for such of those suits as are being defended by the Company's insurance carriers. In the opinion of management, the other suits will have no material effect on the financial statements for 1976.

In August 1976, the Company entered into an agreement to lease a new general office building under a capitalizable lease obligation. This building is being constructed to the Company's specifications at an estimated total cost of $3,900,000.

In December 1976, the Company entered into an agreement to lease a Reservation Call System under a capitalizable lease obligation. This equipment will be put into use in late 1977 at a cost of approximately $900,000.

The Company, in order to comply with the Aviation Noise Abatement Policy of the Department of Transportation, is required to modify 50 per cent of its DC9 aircraft by January 1, 1981 and have all these aircraft modified by January 1, 1983. The estimated cost to modify these aircraft is approximately $5.6 million. Legislation has been proposed to permit financing of a portion of the cost of compliance with this policy by air carriers from special ticket-tax revenues presently allocated to airport development.

Note I — Earnings Per Share

Primary and fully diluted earnings per share for 1976 were computed by dividing net income, after reduction for the preferred dividend requirement, by the weighted average number of common shares outstanding during the year — 1,580,880 shares. Common equivalent shares (described below) and adjustments resulting from their assumed exercise were excluded from the computation of primary earnings per share for 1976 since their inclusion would have increased earnings per share. Similarly, the assumed conversion of convertible securities was excluded from the computation of fully diluted earnings per share for 1976 since the result of such conversions would not have been dilutive.

Primary earnings per share for 1975 were computed by dividing net income (adjusted as described below and reduced by the preferred dividend requirement) by the weighted average number of common shares and common equivalent shares outstanding during the year — 1,765,168 shares. Common equivalent shares comprise that number of common shares issuable upon exercise of stock options and warrants in excess of 20 per cent of the number of common shares outstanding at the end of the year. Proceeds from the assumed exercise of the options and warrants in excess of the amount which would have been required to purchase 20 per cent of the outstanding common stock at the average market price during the year were assumed to have been applied to debt reduction and the related interest, net of income tax effect, was added to income for purposes of the calculation.

Fully diluted earnings per share for 1975 were determined on the assumption that the weighted average number of common and common equivalent shares were further increased from the beginning of the year by conversion of outstanding convertible debentures and convertible preferred stock — a total of 2,912,407 shares. This calculation also assumes no preferred dividend requirement, and interest, net of income tax effect, related to the debentures assumed converted, was added to income for purposes of the calculation.

Note J — Supplementary Information

	1976	1975
Depreciation and Amortization:		
Depreciation of property and equipment	$ 4,878,000	$ 4,177,000
Amortization of deferred charges	396,000	388,000
Provision for inventory obsolescence	233,000	203,000
	5,507,000	4,768,000
Deduct — amounts charged to other expense accounts	126,000	134,000
	$ 5,381,000	$4,634,000
Taxes, other than income taxes, charged to operating expenses:		
Payroll taxes	$ 2,352,000	$1,874,000
Fuel and oil taxes	881,000	723,000
Property taxes	782,000	652,000
Sales and use taxes	431,000	360,000
Other	175,000	154,000
	$ 4,621,000	$3,763,000
Rents:		
Rental expense under leases (Note G)	$11,299,000	$9,674,000
Portion of gross lease rentals not charged to rent expense in accordance with CAB classifications and miscellaneous rentals — net	(70,000)	(73,000)
	$11,229,000	$9,601,000
Advertising costs	$ 1,712,000	$ 918,000

There were no royalties or research and development costs.

Note K — Quarterly Results of Operations (unaudited)

The following is a tabulation of the quarterly results of operations for the year ended December 31, 1976:

	Three Months Ended			
	Mar. 31	Jun. 30	Sept. 30	Dec.31
	(Thousands of dollars, except per share data)			
Operating revenues	$32,045	$35,860	$36,087	$36,175
Operating expenses	32,650	33,791	34,370	36,864
Operating income (loss)	(605)	2,069	1,717	(689)
Net income (loss)	(649)	1,149	827	(922)
Net income (loss) per common and common equivalent share:				
Primary	(.42)	.65	.47	(.59)
Fully diluted	(.42)	.45	.33	(.59)

Quarterly earnings per share do not total earnings per share for the year because the computation of earnings per share on a quarterly basis included certain common stock equivalents which were not included in the earnings per share computation on an annual basis.

Note L — Replacement Cost of Property and Equipment (unaudited)

The Company has estimated certain replacement cost information for flight equipment and ground property and equipment, and has elected to present this information in its annual report to the Securities and Exchange Commission on Form 10-K, a copy of which is available upon request. Form 10-K contains specific information with respect to the approximate replacement cost of flight equipment and ground property and equipment at December 31, 1976, and the approximate effect which replacement cost would have had on depreciation expense for the year, as compiled in accordance with the rules of the Commission. Replacing items of property and equipment with assets having an equivalent capacity has generally required a greater capital investment than was required to purchase the assets which are being replaced due to the cumulative impact of inflation.

Note M — Subsequent Event

On March 18, 1977 the Company signed a purchase agreement with Swearingen Aviation Corporation for the purchase of seven new Metro II aircraft and related spare parts to be delivered from June 1977 through January 1978. These turboprop transports have a capacity of 19 passengers and cruise at speeds of approximately 300 miles per hour. The total cost of these aircraft including related spare parts and equipment is expected to approximate $7,750,000.

The purchase agreement is subject to the Company obtaining the required financing. A deposit of $175,000 was made in connection with the agreement and is subject to forfeiture if the financing is not obtained by May 15, 1977.

REPORT OF ERNST & ERNST, Independent Auditors

Board of Directors
Southern Airways, Inc.
Atlanta, Georgia

We have examined the balance sheet of Southern Airways, Inc. as of December 31, 1976, and December 31, 1975, and the related statements of income, stockholders' equity and changes in financial position for the years then ended. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the financial statements referred to above present fairly the financial position of Southern Airways, Inc. at December 31, 1976, and December 31, 1975, and the results of its operations and changes in its financial position for the years then ended in conformity with generally accepted accounting principles applied on a consistent basis.

Atlanta, Georgia
January 31, 1977, except
as to Note M as to which
the date is March 18, 1977

Ernst & Ernst

E&E

Notice to Stockholders of Southern Airways, Inc.

Any person who owns as of December 31 of any year, or subsequently acquires ownership, either personally or as a trustee, of more than five per cent (5%) in the aggregate of any class of capital stock or capital of Southern Airways, Inc. shall file with the Civil Aeronautics Board a report containing the information required by Part 245.12 of the Board's Economic Regulations. This report must be filed on or before April 1 of each year as to the capital stock or capital owned as of December 31 of the preceding year; and in the case of capital subsequently acquired, a report must be filed within ten (10) days after such acquisition, unless such person has otherwise filed with the Civil Aeronautics Board a report covering such acquisition or ownership.

Any bank or broker covered by this provision, to the extent that it holds shares as trustee on the last day of any quarter of a calendar year, shall file with the Civil Aeronautics Board within thirty (30) days after the end of the quarter, a report in accordance with the provisions of Part 245.14 of the Board's Economic Regulations.

Any person required to report pursuant to these provisions who grants a security interest in more than five per cent (5%) of any class of the capital stock or capital of an air carrier, shall within thirty (30) days after granting such security interest, file with the Civil Aeronautics Board a report containing the information required in Part 245.15 of the Economic Regulations.

Any stockholder who believes that he may be required to file such a report may obtain further information by writing to the Director, Bureau of Operating Rights, Civil Aeronautics Board, Washington, D.C. 20428.

Equal Opportunity Policy

It is the policy and practice of Southern Airways, Inc. to recruit, hire and promote qualified applicants regardless of their race, color, religion, sex, age, national origin, or physical handicap.

To further this objective, the Company has established procedures to insure that all personnel actions such as compensation, benefits, transfers, layoffs, returns from layoffs, Company sponsored training, education, tuition assistance, social and recreational programs, and all Company facilities are administered without regard to race, color, religion, sex, age, national origin, or physical handicap.

Directors and Officers

Directors

CECIL A. BEASLEY, JR.
Assistant Secretary,
Southern Airways, Inc. and
Partner — Ballard, Beasley and Nelson
(Attorneys) Washington, D.C.

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Executive Vice President and
General Manager,
Southern Airways, Inc.

GRAYDON HALL*
President,
Southern Airways, Inc.

F. BARTON HARVEY, JR.
Partner — Alex. Brown & Sons
(Investment Bankers)
Baltimore, Maryland

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Chairman of the Board and
Chief Executive Officer
Southern Airways, Inc.

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Chairman of the Board
Fred S. James & Company of
Georgia, Inc. (Insurance Agents
and Counselors)
Atlanta, Georgia

HENRY P. JOHNSTON†
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Birmingham, Alabama

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Columbus, Georgia

SARTAIN LANIER**
Chairman of the Board
Oxford Industries, Inc.
(Textile Manufacturer)
Atlanta, Georgia

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Vice President — Finance
and Treasurer,
Southern Airways, Inc.

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Chairman of the Board and Chief
Executive Officer — Pan American
Life Insurance Company
New Orleans, Louisiana

F. D. SCHAS†
Retired Investment Counselor
Memphis, Tennessee

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Chairman and Founder
EBSCO Industries, Inc.
(Diversified Multinational Sales
Corporation and Metals Manufacturing)
Birmingham, Alabama

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President — Union Planters
National Bank
Memphis, Tennessee

WM. BEW WHITE, JR.*
Assistant Secretary,
Southern Airways, Inc. and
Partner — Bradley, Arant, Rose & White
(Attorneys)
Birmingham, Alabama

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Chairman and Chief
Executive Officer

GRAYDON HALL
President

GEORGE M. GROSS
Executive Vice President
and General Manager

J. KENNETH COURTENAY
Vice President — Economic
Regulations and Secretary

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Vice President — Finance
and Treasurer

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System Planning

WILLIAM E. OAKES
Assistant Vice President —
Economic Research

CECIL A. BEASLEY, JR.
Assistant Secretary

MARY C. HAYES
Assistant Secretary

WM. BEW WHITE, JR.
Assistant Secretary

**Member of Executive Committee*
***Member of Audit Committee*
†Senior Director

Southern

Southern Airways, Inc.
General Offices
Hartsfield Atlanta International Airport
Atlanta, Georgia 30320

General Information

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Bradley, Arant, Rose & White
Birmingham, Alabama
Ballard, Beasley and Nelson
Washington, D.C.

Auditors
Ernst & Ernst
Atlanta, Georgia

Stock Transfer Agent
Trust Company Bank
Atlanta, Georgia

Form 10-K
A copy of the Company's Annual Report to the Securities and Exchange Commission on Form 10-K is available to the Company's securities holders, without charge, on request to:

Mr. A. L. Maxson
Vice President — Finance and Treasurer
Southern Airways, Inc.
Hartsfield Atlanta International Airport
Atlanta, Georgia 30320

Designed and printed by
Stein Printing Company
Atlanta, Georgia

Southern

Southern Airways, Inc.
General Offices
Hartsfield Atlanta International Airport
Atlanta, Georgia 30320