Southern

Southern Airways, Inc.
1978 Annual Report

Southern

Southern Airways, Inc. is a certificated, scheduled airline engaged in transportation of persons, property and mail. The Company serves 18 states, the District of Columbia, and the Cayman Islands in the British West Indies.

Southern began scheduled service on June 10, 1949. During 1978, the Company's aircraft flew almost 34 million miles, serving more than 4.1 million passengers. Aircraft in service include 30 DC9 jetliners and eight Metro II turboprops. Today, more than 98 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 4,500 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 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 fares and quality of service are competitive.

On February 22, 1979, the shareholders of Southern voted to merge with North Central Airlines, Inc. Such merger is subject to approval of certain creditors, the Civil Aeronautics Board and the President of the United States.

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

Market Price of Common Stock

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

	Bid Price		Asked Price	
Year	High	Low	High	Low
1977				
First Quarter	4⅛	3¾	4½	4⅛
Second Quarter	4⅛	3⅝	4½	4
Third Quarter	4⅛	3⅝	4½	4
Fourth Quarter	5	4⅛	5⅜	4½
1978				
First Quarter	6⅞	5	7¼	5⅜
Second Quarter	8	6⅜	8⅜	6¾
Third Quarter	16¾	7⅝	17¾	8
Fourth Quarter	13¼	7¾	14¼	8¾
1979				
First Quarter through February 26	13½	11½	14½	12¼

On July 12, 1978, the day immediately preceding public announcement of a proposed merger with North Central Airlines, Inc., the closing bid and asked prices of Southern's common stock were $8.00 and $8.375, respectively.

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 subordinated debentures or warrants.

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Report to Stockholders

Clearly, the most significant event in 1978 was the announcement in July of the proposed merger of your Company and North Central Airlines, Inc., headquartered in Minneapolis, Minnesota. Upon the approval of the merger, these strong, regional carriers will become a coast-to-coast, national air carrier of considerable strength and potential. The new Company will be named Republic Airlines, Inc.

Republic will serve some 150 cities and will generate an expected $700 million in revenue in its first full year. By linking the two strong regional systems over major connecting "bridge" routes, many small and medium-size cities on both systems will receive significantly improved, more frequent single-carrier and single-plane service. This, in turn, will generate additional revenue greater than for each carrier separately. With corresponding cost efficiencies, the profit potential will be enhanced.

The merger has been approved by the stockholders and directors of both companies and has been recommended favorably by an administrative law judge of the Civil Aeronautics Board. Consummation of the merger now is awaiting final approval of the Board and the President of the United States. This action is expected by mid-year.

Upon completion of the merger, Southern's stockholders will receive 2.1 shares of common stock of North Central (Republic) for each share of Southern common stock. The conversion ratio on Southern's convertible debentures and the exercise rights on Southern's warrants will be amended to reflect the same exchange ratio.

In 1978, Southern earned $2.4 million, or $1.29 per share primary, on total revenues of $188.5 million. This compares with a profit of $9.3 million, or $5.39 per share primary, in 1977 (after restatement to comply with Financial Accounting Standards Board Statement No. 13, "Accounting for Leases") on total revenues of $159.5 million. A $3.9 million gain from an insurance settlement contributed to 1977 results.

Although revenue passenger miles increased a significant 27.8 per cent in 1978, this was not sufficient to overcome a four per cent decline in revenue per passenger mile caused by the proliferation of discount fares and the inflationary effects on costs, and still maintain 1977's profit margin. A more thorough review of the financial results is contained in Management's Discussion on the following pages.

Southern and North Central, as well as the travelling public, will all benefit substantially from the merger. Together the two carriers can draw from the strengths of the other to produce a new airline stronger and better qualified to provide the best in air transportation service and to compete effectively in whatever regulatory environment the coming years may bring.

Respectfully submitted,

Frank W. Hulse
Chairman

Graydon Hall
Vice Chairman

George M. Gross
President

March 30, 1979

Highlights

Year ended December 31	1978	1977	%
PASSENGER REVENUES	$ 159,802,000	$ 130,828,000	22.1
OPERATING REVENUES	$ 188,512,000	$ 159,511,000	18.2
OPERATING INCOME	$ 7,706,000	$ 9,260,000	(16.8)
NET INCOME	$ 2,407,000*	$ 9,342,000**	(74.2)
PRIMARY EARNINGS PER SHARE	$ 1.29*	$ 5.39**	(76.1)
REVENUE PER PASSENGER MILE	$ 0.120	$ 0.125	(4.0)
SCHEDULED SERVICE REVENUE PASSENGER MILES	1,334,987,000	1,044,818,000	27.8
AVAILABLE SEAT MILES	2,449,402,000	2,043,061,000	19.9
PASSENGER LOAD FACTOR	54.5%	51.1%	6.7
REVENUE PASSENGERS CARRIED	4,111,000	3,457,000	18.9
REVENUE PLANE MILES FLOWN	33,977,000	28,638,000	18.6
NUMBER OF EMPLOYEES	3,216	2,922	10.1

*Includes gain from sale of four engines which increased net income by $660,000 (32 cents per share).

**Includes excess insurance proceeds from the loss of a DC9 aircraft which increased net income by $3,922,000 ($2.26 per share). Also includes prior years' mail revenue which increased net income by $500,000 (29 cents per share).

The Company's 1977 financial statements have been restated in accordance with FASB Statement No. 13, "Accounting for Leases".

These highlights should be read in conjunction with the Financial Statements and Notes to the Financial Statements appearing elsewhere in this report.

Management's Discussion of 1978 and 1977 Summary of Operations

Overview

Net income in 1978 was $2,407,000 ($1.29 per share), compared to net income of $9,342,000 ($5.39 per share) in 1977 after restatement to comply with FASB Statement No. 13, "Accounting for Leases", and $325,000 (17 cents per share) in 1976. In each of the years significant traffic growth was offset by increases in operating costs, both from inflationary sources and the cost to provide additional service to the public.

Capital gains and items of a nonrecurring nature added approximately $660,000 (32 cents per share) to net income in 1978, $4,422,000 ($2.55 per share) to 1977 and $145,000 (nine cents per share) to 1976. Exclusive of the effect of these items, net income would have been approximately $1,747,000 (97 cents per share) in 1978, $4,920,000 ($2.84 per share) in 1977, and $180,000 (eight cents per share) in 1976.

Operating Revenues

Total operating revenues reached record levels of $188,512,000 in 1978 and $159,511,000 in 1977, up 18.2 per cent and 13.8 per cent, respectively, compared with prior years.

Passenger revenues of $159,802,000 in 1978 represented a 22.1 per cent gain over the prior year, while the $130,828,000 in passenger revenues in 1977 reflected a 13.6 per cent gain over 1976.

Capacity, as measured by available seat miles (ASMs), was increased by 14.6 per cent in 1978 following a 5.7 per cent increase in 1977. These increases were brought about by the addition of two DC9 and one Metro aircraft in 1978 and alterations to increase the capacity of existing DC9 aircraft in 1978 and 1977.

Yield (revenue per passenger mile) increased from 11.7¢ in 1976 to 12.5¢ in 1977 and decreased to 12.0¢ in 1978. The improvements from 1976 to 1977 reflected certain fare increases throughout the period and the elimination of certain discount fares in 1976. The decrease in 1978 is a result of the introduction of new discount fares early in the year.

Charter revenues decreased by $2,432,000 from 1977 to 1978 due to the phasing out of the Company's charter operations to more profitably use the aircraft in scheduled services. The Company anticipates flying very few charters in 1979.

Other revenues increased by $3,352,000 in 1978 and by $3,434,000 in 1977. Contract maintenance revenues, airframe and engine work performed for others initiated in 1978, contributed $2,683,000 to other revenues. Freight revenue increased $1,846,000 in 1978 and $2,477,000 in 1977 over the previous years. Included in the 1977 increase was $1,012,000 of additional mail revenue received by the Company under a Civil Aeronautics Board's order establishing permanent rates for the carriage of mail for the period 1973 through 1976. (See Note B of Notes to Financial Statements.)

Operating and Other Expenses

Operating expenses increased by $30,555,000 in 1978, following a $14,686,000 increase in 1977. Labor costs increased $13,590,000 in 1978 and $6,847,000 in 1977, as a result of increased salaries and benefits. The total number of employees at the end of 1978 was up considerably over prior year-end levels because of the expansion of in-house aircraft engine maintenance, contract maintenance for others, and a greater volume of flying operations. There were 3,216 employees at December 31, 1978, compared with 2,922 at December 31, 1977, and 2,766 at December 31, 1976.

The cost of aircraft fuels and oils increased by $5,265,000 in 1978 and $4,917,000 in 1977 over the previous year. Of these amounts, increased fuel consumption accounted for $3,490,000 and $939,000, respectively, while the balance of the differences were caused by the increase in the unit cost of fuel. Increased fuel consumption was a result of increases in the number of aircraft flown on the system.

Depreciation and amortization expense increased by $2,230,000 in 1978 and $861,000 in 1977 over the prior year due primarily to additional aircraft in service and new facilities. The 1978 increase resulted primarily from the introduction of the new Metro aircraft in late 1977 and the purchase of two additional DC9-10 aircraft in 1978, while the 1977 increase was due primarily to depreciation on the newly purchased Metro aircraft, and depreciation for a full year on two DC9-30 aircraft added in June and August 1976.

Increases in other operating costs, such as outside goods and services, commissions, and costs relating to contract maintenance work performed for others, generally are reflective of the expanded operating levels and inflationary pressures.

As a result of increased debt to finance various capital additions, along with significant increases in the prime interest rate during 1978, interest expense increased $2,262,000 from 1977 and $2,218,000 from 1976.

Included in Miscellaneous Deductions (Income) in 1978 is a gain of $1,166,000 from the sale of four engines. In 1977, this classification included the excess of insurance proceeds over the purchase price on the loss of an aircraft, amounting to $5,823,000.

The increase in the effective tax rate from 1977 to 1978 was a result of the capitalization of certain expenses in 1978 for tax purposes and greater capital gains benefits in 1977 than in 1978. Additionally, the tax rate in 1977 as compared to the tax rate in 1978 was affected by the amount of investment tax credit. The decrease in the effective tax rate from 1976 to 1977 was a result of the more favorable capital gain rate applied to income in 1977 relating to the excess insurance proceeds on the loss of an aircraft. (See Note E of Notes to Financial Statements.)

REPORT OF ERNST & ERNST, Independent Auditors

Board of Directors
Southern Airways, Inc.
Atlanta, Georgia

We have examined the balance sheets of Southern Airways, Inc. as of December 31, 1978 and 1977, 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.

As discussed in Note E to the financial statements, the Company in 1978 amended the lease relating to its maintenance base and training facility and capitalized the lease for income tax purposes. As a result, the Company may be entitled to reduce income taxes for 1975, 1976 and 1977 by approximately $800,000 because of investment tax credits related to the lease. Because of the technical issues involved the Internal Revenue Service has not approved the Company's returns. Accordingly, no amounts have been included in the accompanying financial statements to recognize the income arising from the investment tax credits that may be realized upon the final resolution of this matter.

In our opinion, subject to the effects, if any, on the financial statements of the ultimate resolution of the matter discussed in the preceding paragraph, the financial statements referred to above present fairly the financial position of Southern Airways, Inc. at December 31, 1978 and 1977, 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 after restatement for the change, with which we concur, in the method of accounting for leases as described in Note B to the Financial Statements.

Atlanta, Georgia
February 9, 1979

Ernst & Ernst

E&E

Notice to Stockholders of Southern Airways, Inc.

Any person who owns, as of December 31 of any year, or subsequently acquired 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 the 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 Economics 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.

Statements of Income
SOUTHERN AIRWAYS, INC.

Year ended December 31,	1978	1977 (As Restated)
Operating Revenues		
Passenger	$159,802,000	$130,828,000
Mail, express and freight—Note B	10,180,000	9,325,000
Public service revenue—Note A	4,327,000	5,220,000
Charter	7,162,000	9,594,000
Other	7,041,000	4,544,000
	188,512,000	159,511,000
Operating Expenses		
Flying operations	60,059,000	50,540,000
Maintenance	22,603,000	20,962,000
Aircraft and traffic servicing	42,652,000	36,078,000
Passenger service	10,962,000	8,566,000
Promotion and sales	16,716,000	12,894,000
General and administrative	9,916,000	8,182,000
Depreciation and amortization	12,900,000	10,670,000
Other	4,998,000	2,359,000
	180,806,000	150,251,000
Operating Income	7,706,000	9,260,000
Other Deductions (Income)		
Interest on long-term debt	6,905,000	4,643,000
Gain on involuntary conversion and disposal of property—Note B	(1,356,000)	(6,199,000)
Miscellaneous deductions (income)—net	(1,159,000)	(407,000)
	4,390,000	(1,963,000)
Income Before Income Taxes	3,316,000	11,223,000
Income taxes—Note E	909,000	1,881,000
Net Income	$ 2,407,000	$ 9,342,000
Net Income per Common and Common Equivalent Share — Note I		
Primary	$ 1.29	$ 5.39
Fully diluted	$ .93	$ 3.45

See Notes to Financial Statements

Balance Sheets
SOUTHERN AIRWAYS, INC.

Assets	December 31, 1978	1977 (As Restated)
Current Assets		
Cash, including short-term investments of $5,263,000 in 1978 and $10,312,000 in 1977—Note C	**$ 11,747,000**	$ 11,005,000
Accounts receivable		
U.S. Government—transportation and public service revenue	**1,853,000**	2,984,000
Trade receivables, less allowance for doubtful accounts (1978—$190,000; 1977—$179,000)	**14,048,000**	13,677,000
	15,901,000	16,661,000
Maintenance and operating supplies, at average cost less allowance for obsolescence (1978—$1,397,000; 1977—$1,063,000)—Note A	**9,406,000**	6,759,000
Prepaid expenses	**481,000**	507,000
Total Current Assets	**37,535,000**	34,932,000
Property and Equipment—on the basis of cost—Notes A, C, D, H and L		
Flight equipment, including purchase deposits of $1,331,000 in 1978 and $3,390,000 in 1977	**111,164,000**	103,756,000
Other property and equipment	**20,979,000**	16,476,000
	132,143,000	120,232,000
Less allowances for depreciation and maintenance	**51,490,000**	40,998,000
	80,653,000	79,234,000
Deferred Charges and Other Assets		
Deferred charges—Note A	**1,893,000**	1,862,000
Other assets	**489,000**	565,000
	2,382,000	2,427,000
	$120,570,000	$116,593,000

See Notes to Financial Statements

Liabilities and Stockholders' Equity

	December 31, 1978	1977 (As Restated)
Current Liabilities		
Trade accounts payable	**$ 6,657,000**	$ 7,390,000
Salaries, wages and vacations	**5,514,000**	4,346,000
Accrued interest payable	**1,036,000**	782,000
Accrued income taxes	**2,039,000**	2,014,000
Accrued taxes and other expenses	**4,792,000**	3,662,000
Air traffic liability	**10,313,000**	9,471,000
Current maturities of long-term debt—Note C	**8,329,000**	9,615,000
Total Current Liabilities	**38,680,000**	37,280,000
Long-Term Debt, less current maturities—Note C		
Notes payable and other	**50,300,000**	50,724,000
Convertible subordinated debentures	**7,270,000**	8,289,000
	57,570,000	59,013,000
Deferred Credits—Note H	**644,000**	314,000
Stockholders' Equity—Notes C, D and F		
Preferred Stock, authorized 2,000,000 shares, issuable in series: Series A, $.36 Convertible, $1 par value, voting; issued and outstanding—163,581 shares (1977)	–	164,000
Common Stock, $2 par value, authorized 7,500,000 shares, issued and outstanding 1,896,288 shares (1978) and 1,581,080 shares (1977)	**3,793,000**	3,162,000
Other paid-in capital	**5,981,000**	5,124,000
Retained earnings	**13,902,000**	11,536,000
	23,676,000	19,986,000
Leases, Commitments and Contingencies—Notes B, D and H		
	$120,570,000	$116,593,000

Statements of Changes in Financial Position

SOUTHERN AIRWAYS, INC.

Year ended December 31,	1978	1977 (As Restated)
Funds Provided		
From operations		
Net income	**$ 2,407,000**	$ 9,342,000
Items not requiring outlay of working capital in current period:		
Depreciation	**12,412,000**	10,171,000
Increase in allowance for maintenance	**11,000**	158,000
Amortization of deferred charges	**377,000**	370,000
Deferred credits and other liabilities	**330,000**	93,000
Total from operations	**15,537,000**	20,134,000
Issuance of long-term debt	**33,555,000**	29,076,000
Conversion of debentures to common stock	**1,051,000**	—
Preferred stock converted to common stock	**159,000**	—
Options and warrants exercised	**321,000**	—
Property and equipment dispositions, less gain included in operations	**2,623,000**	6,187,000
	53,246,000	55,397,000
Funds Used		
Additions to property and equipment	**16,000,000**	34,860,000
Utilization of DC9 engine maintenance reserve	**465,000**	292,000
Reduction of long-term debt	**33,947,000**	19,508,000
Conversion of debentures to common stock	**1,051,000**	—
Preferred stock converted to common stock	**159,000**	—
Redemption of preferred stock	**25,000**	—
Increase in deferred charges and other assets	**355,000**	1,120,000
Dividends on preferred stock	**41,000**	118,000
	52,043,000	55,898,000
Increase (Decrease) in Working Capital	**1,203,000**	(501,000)
Working capital (deficit) at beginning of period	**(2,348,000)**	(1,847,000)
Working Capital (Deficit) at End of Period	**$ (1,145,000)**	$(2,348,000)
Increase (Decrease) in Working Capital by Component		
Cash and short-term investments	**$ 742,000**	$ 2,874,000
Accounts receivable	**(760,000)**	3,466,000
Maintenance and operating supplies	**2,647,000**	753,000
Prepaid expenses	**(26,000)**	(467,000)
Trade accounts payable	**733,000**	(1,127,000)
Salaries, wages and vacations	**(1,168,000)**	(432,000)
Accrued interest, taxes, and other expenses	**(1,409,000)**	(2,056,000)
Air traffic liability	**(842,000)**	(1,555,000)
Current maturities of long-term debt	**1,286,000**	(1,957,000)
Increase (Decrease) in Working Capital	**$ 1,203,000**	$ (501,000)

See Notes to Financial Statements

Statements of Stockholders' Equity
SOUTHERN AIRWAYS, INC.

	Preferred Stock Series A $1 Par Value	Common Stock $2 Par Value	Other Paid-In Capital	Retained Earnings
Balance January 1, 1977, as originally reported	$164,000	$3,162,000	$5,124,000	$ 4,796,000
Effect of change in method of accounting for leases—Note B	—	—	—	(2,484,000)
Balance January 1, 1977, as restated	164,000	3,162,000	5,124,000	2,312,000
Net income	—	—	—	9,342,000
Dividends on preferred stock	—	—	—	(118,000)
Balance December 31, 1977	164,000	3,162,000	5,124,000	11,536,000
Net income	—	—	—	2,407,000
Dividends on preferred stock	—	—	—	(41,000)
Conversion and redemption of preferred stock	(164,000)	318,000	(181,000)	—
Exercise of options and warrants	—	110,000	211,000	—
Conversion of $593,000 of 6-1/2% Convertible Subordinated Debentures (less $16,000 deferred finance costs)	—	119,000	458,000	—
Conversion of $458,000 of 5-3/4% Convertible Subordinated Debentures (less $5,000 deferred finance costs)	—	84,000	369,000	—
Balance December 31, 1978	$ —	$3,793,000	$5,981,000	$13,902,000

See Notes to Financial Statements

Notes to Financial Statements
SOUTHERN AIRWAYS, INC.
December 31, 1978

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 five to 10 years (used equipment) and 10 years for rotable parts, with a 10 per cent salvage value; for Metro II flight equipment, the life is seven years with a 10 per cent salvage value; for the general office building the life is 30 years; for ground equipment, the life ranges from three to 10 years.

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

Expenditures for ordinary maintenance and repairs are charged to expense. Expenditures for major spare parts are capitalized and minor parts are included in maintenance and operating supplies and charged to expense as used.

A provision for obsolescence is made at an annual rate of four per cent and six per cent for DC9 and Metro II spare parts, respectively.

Deferred Charges

Expenditures for preoperating and route extension and development costs are deferred and are amortized over a five year period. Costs associated with obtaining leased DC9 aircraft are amortized over the term of the leases. Deferred charges associated with long-term debt are amortized over the periods of the financial 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, 1978, the assets of the pension fund exceeded the actuarially computed value of vested benefits.

Employee Stock Ownership Plans

The Company has an Employee Stock Ownership Plan (ESOP) and a Tax Reduction Act Stock Ownership Plan (TRASOP) for certain of its employees. The TRASOP was established effective January 1, 1977. The Company's contribution to the ESOP is determined annually at rates related to the base compensation of active participants. The TRASOP is funded by the additional one per cent investment tax credit allowed for such plans.

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. Since July 1, 1978, the Company has been receiving subsidy under a temporary rate in anticipation of a new subsidy rate which will be adjusted retroactively to July 1, 1978, when the rate is finalized. If the final rate, when determined, follows the pattern the Board has in the past established in determining final rates, the amount to be received by the Company from the CAB as public service revenue will not substantially differ from the amount received under the temporary rate.

Note B—Certain Significant Transactions and Credits Affecting Operating Results

The Company sold four DC9 engines during 1978. The gain on the sale was $1,166,000 ($660,000 or 32 cents per share primary after income taxes).

The Company's financial statements have been restated to reflect the accounting for certain operating leases entered into prior to January 1, 1977, as capital leases by recording assets and liabilities for leased property and equipment in accordance with FASB Statement No. 13, "Accounting for Leases". The effect of this change is recorded as an adjustment of beginning retained earnings for the year 1977. Net income for 1977 was increased by $1,089,000 ($.63 per share primary).

On April 4, 1977, a DC9 aircraft was destroyed during severe weather conditions near Atlanta, Georgia. A number of claims have been made and are expected to be made against the Company for loss of life, injury, and damage to property as a result of this accident. In the opinion of management, the claims are adequately covered by insurance. Insurance proceeds in excess of the purchase price of the leased aircraft and other related costs were $5,823,000 ($3,922,000 or $2.26 per share primary after income tax effect).

On December 29, 1977, the CAB issued an order establishing temporary rates for the carriage of mail during the period 1973 through 1977 as a continuing part of the Priority and Nonpriority Domestic Service Mail Rates Investigation instituted in December 1970. Under the order, Southern received $1,012,000 of additional mail revenue applicable to the years 1973 through 1976, which is included in mail, express and freight revenue for 1977. The additional revenue had the effect of increasing net income for 1977 by approximately $500,000 (29 cents per share primary). In November 1978, the CAB issued a final order substantially confirming the mail rates through 1977 and establishing a procedure for adjusting mail rates for cost increases for years beginning with 1978. The final order had the effect of increasing net income in 1978 by $54,000 (three cents per share primary).

Note C—Long-Term Debt

At December 31,	1978	1977
Notes payable to banks		
under Credit Agreement		
"A" Term Loans, payable quarterly through 1982	**$ 8,742,000**	$10,962,000
"B" Revolving Loans, payable quarterly through 1985	**3,000,000**	4,000,000
"C" Term Loans, payable quarterly through 1984	**5,065,000**	6,029,000
Other notes payable		
Term note payable quarterly through 1988	**7,142,000**	7,303,000
Term note payable quarterly through 1987	**9,957,000**	10,752,000
Term notes payable quarterly through 1986	**5,813,000**	—
Promissory notes	—	2,516,000
Convertible Subordinated Debentures		
5-3/4% due December 1, 1981	**3,016,000**	3,474,000
6-1/2% due November 1, 1983	**5,047,000**	5,833,000
Capital lease obligations—Note D	**18,117,000**	17,759,000
	65,899,000	68,628,000
Less current maturities	**8,329,000**	9,615,000
	$57,570,000	$59,013,000

Notes payable to banks under the Credit Agreement bear interest at the lead bank's prime rate (11-3/4 per cent at December 31, 1978), plus one per cent ("A" and "C" Term Loans) and one and one half per cent ("B" Revolving Loan) and are payable in quarterly installments. Substantially all the Company's assets not pledged as collateral under the term notes described below 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.

In November 1978, the Company expanded the "B" Revolving Loan commitment to a maximum of $16.5 million. The new "B" Revolving Loan requires quarterly reductions in the commitment of $590,000 beginning February 1979 and continuing through November 1, 1985. Additionally, reductions under the new "B" Revolving Loan commitment are required equal to 50 per cent of net income in excess of $4,000,000 earned in any fiscal year.

The term note due in 1988 is payable in forty quarterly consecutive installments beginning May 1, 1978, plus interest at prime plus 2-1/2 per cent. The Metroliner II flight equipment purchased with the loan proceeds is pledged as collateral under the note.

The term note due in 1987 is composed of a Class A Note ($1,003,000) and a Class B Note ($8,954,000), both payable in forty quarterly installments with interest at 10 per cent and 8-1/4 per cent, respectively. The proceeds of the note were used to purchase six DC9-10 aircraft previously leased. These aircraft are pledged as collateral under the terms of the Agreement. Additionally, the Class B Note is 90 per cent guaranteed by the Federal Aviation Administration.

The term notes due in 1986 are payable in equal quarterly installments, together with interest at the rate of 11 per cent per year over an eight year term. The notes are secured by a mortgage on three DC9 aircraft and three spare engines.

The promissory note of $2,516,000 at December 31, 1977, was refinanced as a portion of the "B" Revolving Loan.

The 5-3/4 per cent Convertible Subordinated Debentures due December 1, 1981, are convertible 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 three-fourths of one per cent downward; and require annual sinking fund payments on December 1 of each year in an amount equal to $435,000.

The 6-1/2 per cent Convertible Subordinated Debentures due November 1, 1983, are convertible 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 two per cent downward; and require annual sinking fund payments which began November 1, 1978, in an amount equal to $583,000.

The terms of the Credit Agreement, the term note due in 1987 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 under the most restrictive requirement amounted to approximately $2,950,000 at December 31, 1978.

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 outstanding of the "A" Loan, 20 per cent of the average daily balance outstanding of the "B" Revolving Loan, 10 per cent of the unused portion of the "B" Revolving Loan Commitment, and 20 per cent of the average daily balance of the "C" Loan outstanding. Based upon outstanding borrowings at December 31, 1978, the Company should maintain average compensating balances of approximately $4,512,000 which stated in terms of the Company's book cash balances is approximately $2,668,000. The difference is attributable to average uncollected funds and float. During 1978, the Company maintained average compensating balances of approximately $4,984,000. 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.

A summary of minimum principal payments for the five years ended December 31, 1983 applicable to long-term debt including capital lease obligations, is as follows:

1979	$ 8,329,000
1980	8,484,000
1981	10,169,000
1982	10,401,000
1983	8,838,000
Thereafter	19,678,000
	$65,899,000

Substantially all interest capitalized ($98,000 in 1978 and $116,000 in 1977) is related to cash deposits for the purchase of aircraft and aircraft modifications. If the Company did not have a policy of capitalizing interest, net income would have been reduced by $38,000 (2 cents per share primary) and $57,000 (3 cents per share primary), in 1978 and 1977, respectively.

Note D—Leases

The Company leases flight equipment, its maintenance and training center, its general office building, airport terminal space, and other property and equipment.

The following is a summary of leased property under capital leases included in property and equipment at December 31, 1978 and 1977:

	1978	1977
Flight equipment	**$21,116,000**	$19,973,000
Ground property and equipment	**8,936,000**	7,198,000
	30,052,000	27,171,000
Less accumulated amortization	**13,943,000**	11,196,000
	$16,109,000	$15,975,000

Amortization of amounts capitalized as the cost of property and equipment is included in depreciation expense.

At December 31, 1978, future minimum rental payments under capital leases and non-cancellable operating leases that have initial or remaining terms equal to or exceeding one year are as follows:

	Operating Leases	Capital Leases
1979	$ 4,886,000	$ 4,169,000
1980	4,678,000	3,824,000
1981	4,506,000	3,453,000
1982	4,396,000	3,324,000
1983	4,215,000	2,847,000
Subsequent to 1983	74,166,000	14,658,000
Total minimum lease payments	$96,847,000	32,275,000
Amounts representing interest		14,158,000
Present value of future minimum lease payments		$18,117,000

Rental expense included in operations for 1978 and 1977 was $6,055,000 and $5,653,000, respectively. Contingent rentals and rentals received from subleases are immaterial.

The Company has an agreement with the City of Atlanta to lease passenger gates and other airport facilities at a new terminal to be operational in late 1981. The terms of the lease call for annual net rental payments of approximately $2,000,000 over a thirty year period.

Note E—Income Taxes

Income taxes are as follows:

	1978	1977
Current:		
Federal	**$1,774,000**	$3,798,000
State	**183,000**	530,000
Investment tax credit	**(910,000)**	(2,217,000)
	1,047,000	2,111,000
Deferred:		
Federal	**(124,000)**	101,000
State	**(14,000)**	38,000
Investment tax credit	—	(369,000)
	(138,000)	(230,000)
	$ 909,000	$1,881,000

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

	1978	1977
Capitalization of leases	**$ 98,000**	$ 327,000
Accelerated depreciation	**(84,000)**	(390,000)
Provision for inventory obsolescence	**38,000**	295,000
Provision for maintenance	**(39,000)**	(35,000)
Deferred compensation	**(140,000)**	(46,000)
Other	**(11,000)**	(12,000)
Investment tax credit	—	(369,000)
	$ (138,000)	$ (230,000)

Differences between income taxes and amounts derived by applying the statutory federal income tax rate of 48 per cent to income before income taxes are as follows:

	1978 Amount	1978 %	1977 Amount	1977 %
Computed at statutory federal income tax rate of 48 per cent	**$1,592,000**	48	$5,387,000	48
State income taxes, net of federal income tax benefit	**86,000**	3	295,000	3
Capital gains	**(84,000)**	(2)	(963,000)	(9)
Investment tax credit	**(910,000)**	(28)	(2,586,000)	(23)
Capitalizable expenses	**200,000**	6	—	—
Other	**25,000**	0	(252,000)	(2)
	$ 909,000	27	$1,881,000	17

During 1978, the Company amended its lease with the City of Atlanta relating to its maintenance base and training facilities. As a result of this amendment to the lease agreement, the Company amended its 1975 and 1976 tax returns and filed its 1977 tax return reflecting the lease as a capitalized lease for tax purposes. As a result of recording this lease for tax purposes as a capitalized lease, the Company reduced income taxes for 1975, 1976 and 1977 by approximately $800,000 related to investment tax credit on such assets. Representatives of the Internal Revenue Service have indicated that claims arising from the capitalization of these facilities involve very technical issues and that they are not in a position to approve the Company's returns. Accordingly, no amounts have been included in the accompanying financial statements for investment tax credit related to these assets and the effect of capitalizing these facilities for tax purposes.

Note F—Capital Stock and Options

Authorized common shares include shares reserved for issuance as follows:

At December 31,	1978	1977
For convertible securities conversions:		
5-3/4% Convertible Subordinated Debentures (Note C)	**277,680**	319,853
6-1/2% Convertible Subordinated Debentures (Note C)	**504,700**	583,300
Series A Convertible Preferred Stock	—	163,581
	782,380	1,066,734
For exercise of outstanding warrants at $6 per share, issued with Convertible Preferred Stock	**407,622**	457,229
For options under Qualified Stock Option Plan (4,667 shares in 1978 and 11,000 shares in 1977) and Employee Stock Option Plan (25,000 shares)	**29,667**	36,000
	1,219,669	1,559,963

At December 31, 1978, there were outstanding options for 4,667 shares of Common Stock under the Company's Qualified Stock Option Plan, of which 2,000 shares (at $3.50 per share) expire in 1979, and 2,667 shares (at $2.94 per share) expire in 1980. Option transactions during the two years ended December 31, 1978 are summarized as follows:

	Number of Shares	Option Price Per Share	Option Price Total
Outstanding January 1, 1977 and 1978	11,000	$2.94-$5.81	$46,000
Exercised	(4,999)	2.94-5.81	(24,000)
Expired	(1,000)	5.81	(6,000)
Cancelled	(334)	2.94	(1,000)
Outstanding December 31, 1978	4,667	$2.94-$3.50	$15,000

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

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 year ended December 31, 1977. Options for 4,999 shares of Common Stock were exercised during the year ended December 31, 1978. Options became exercisable as follows:

	1978	1977
Number of Shares	2,333	3,667
Option Price:		
Per Share	$2.94-$3.50	$2.94-$5.81
Total	$7,000	$15,000
Quoted Market Price at Date Exercisable:		
Per Share	$6.00-$8.75	$3.63-$4.50
Total	$18,000	$15,000

Options for 3,778 shares (aggregating $12,000 at option prices) and 7,333 shares (aggregating $34,000 at option prices) were exercisable at December 31, 1978 and December 31, 1977, 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 G—Pension, Employee Stock Ownership, and Incentive Compensation Plans

Pension expense was $4,169,000 in 1978 and $4,032,000 in 1977, including $358,000 in 1978 and $312,000 in 1977 applicable to the Employee Stock Ownership Plan. The Company has an incentive compensation plan under which approximately $46,000 and $410,000 were accrued in 1978 and 1977, respectively.

Note H—Other Commitments and Contingencies

On February 9, 1979, an Administrative Law Judge of the Civil Aeronautics Board rendered a decision approving the merger of the Company and North Central Airlines, Inc. Under the Agreement and Plan of Merger dated September 5, 1978, the Company will be merged into North Central forming a company to be called Republic Airlines, Inc. Based on the adjusted net earnings of the Company for 1978, as defined in the Agreement, each share of Common Stock of Southern will be converted into two and one-tenth (2.1) shares of North Central. Consummation of the merger is subject to approval of certain creditors of both companies, the approval of the Civil Aeronautics Board and the President of the United States.

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 $4,400 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 also has an employment agreement with its President providing for his employment through October 31, 1981 at an annual salary of not less than $90,200. In addition, the agreement permits him to take early retirement any time after October 31, 1981 and receive additional retirement income which with his benefit under the Southern pension plan would equal the retirement benefits he would have received had he worked until normal retirement at age 65. Provision for the amount due under the retirement agreement is being made over a 37 month period beginning October 1, 1978. This agreement terminates upon the effective date of the proposed merger with North Central.

The Company has an agreement with its Vice President and Assistant Secretary, under which he will receive $30,000 per year until retirement in 1983 and thereafter will continue to receive such amount through the Southern pension plan and a supplemental retirement benefit payment. The amount necessary to provide for the supplemental retirement benefit was provided for in 1978.

Additionally, the Company has employment agreements with five other officers which contemplate their continued employment by the Company for periods ranging from three to nine years (until each officer attains the age of 60) at an aggregate annual compensation of $267,000. In the event the proposed merger with North Central is completed, these agreements are terminated.

The Company is the defendant in a number of law suits. In the opinion of management there is adequate insurance coverage for those suits that are being defended by the Company's insurance carriers. In the opinion of management, the other suits are not material to the financial statements for 1978.

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.

In October 1977, the Company signed an agreement with McDonnell Douglas Corporation for the purchase of four DC9-80 aircraft (with an option to lease for a term of 14 years) at the approximate cost of $64 million to be delivered in 1980. In May 1978, the Company converted that agreement into an agreement for the purchase of four new DC9-30 aircraft (for delivery in the first quarter of 1980) and an option for two DC9-80 aircraft (for delivery in 1982). On October 31, 1978, the Company assigned to North Central Airlines, Inc. its agreement with McDonnell Douglas Corporation for the four new DC9-30 aircraft and its option on the DC9-80 aircraft.

The Company currently has a lease commitment for seven additional used DC9-10 aircraft (with an option to purchase four of the seven) for a term of seven years beginning in late 1979 at an annual aggregate net rental of approximately $3,200,000. Additionally, the Company committed to purchase two currently-leased used DC9-10 aircraft at the approximate cost of $4.8 million. The Company has letters of credit from its lead bank totaling $2.6 million relating to the purchase of these two aircraft.

Note I—Earnings per Share

Primary earnings per share for 1978 and 1977 were computed by dividing net income (adjusted as described below and reduced by the preferred dividend requirement of $41,000 and $59,000, respectively) by the weighted average number of common shares and common equivalent shares outstanding during each period (1,839,214 in 1978 and 1,732,923 in 1977). In 1978, common equivalent shares comprised that number of shares issuable upon exercise of stock options and warrants less the shares assumed repurchased from the proceeds of the exercise at the average market price for the period. In 1977, common equivalent shares comprised 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 period. 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.

If shares of preferred stock and debentures converted into common stock during 1978 were assumed converted at the beginning of the period, primary earnings per common and common equivalent share would have been $1.16 or a decrease of 13 cents per share.

Fully diluted earnings per share for the years 1978 and 1977 were determined on the assumption that the weighted average number of common and common equivalent shares for these periods was further increased from the beginning of the period by conversion of outstanding convertible debentures and convertible preferred stock (2,888,288 shares in 1978 and 2,799,826 shares in 1977). These calculations also assume 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

	1978	1977
Depreciation and Amortization:		
Depreciation of property and equipment	**$12,412,000**	$10,171,000
Amortization of deferred charges	**377,000**	370,000
Provision for inventory obsolescence	**344,000**	240,000
	13,133,000	10,781,000
Deduct—amounts charged to other expense accounts	**233,000**	111,000
	$12,900,000	$10,670,000
Taxes, other than income taxes, charged to operating expenses:		
Payroll taxes	**$ 3,131,000**	$ 2,498,000
Fuel and oil taxes	**1,183,000**	1,036,000
Property taxes	**1,136,000**	865,000
Sales and use taxes	**646,000**	473,000
Other	**232,000**	178,000
	$ 6,328,000	$ 5,050,000
Rental expense	**$ 6,055,000**	$ 5,653,000
Advertising expense	**$ 2,419,000**	$ 1,676,000

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 years ended December 31, 1978 and 1977:

	Three Months Ended							
	1978				1977			
	Mar. 31	June 30	Sept. 30	Dec. 31	Mar. 31	June 30	Sept. 30	Dec. 31
	(Thousands of dollars, except per share data)							
Operating revenues	$42,156	$48,093	$49,760	$48,503	$36,794	$38,556	$40,574	$43,587
Operating expenses	43,792	44,849	47,564	44,601	36,406	36,673	37,550	39,622
Operating income (loss)	(1,636)	3,244	2,196	3,902	388	1,883	3,024	3,965
Net income (loss)	(1,592)	1,090	615 (a)	2,294 (b)	(427)	4,950 (c)	1,934	2,885 (d)
Net income (loss) per common and common equivalent share								
Primary	(1.02)	.62	.32 (a)	1.13 (b)	(.28)	2.86 (c)	1.12	1.66 (d)
Fully diluted	(1.02)	.42	.24 (a)	.82 (b)	(.28)	1.80 (c)	.72	1.06 (d)

The above quarterly results for 1977 have been restated in accordance with Financial Accounting Standards Board Statement No. 13, "Accounting for Leases". The increase in net income and net income per common and common equivalent share resulting from the restatement was as follows:

	Three Months Ended			
	1977			
	Mar. 31	June 30	Sept. 30	Dec. 31
Net income (000)	$ 54	$654	$ 65	$316
Net income per common and common equivalent share (primary)	$.03	$.37	$.03	$.18

(a) Includes gain of $323,000 ($187,000 after income taxes — 10 cents per share primary and six cents per share fully diluted) from the sale of a DC9 engine. See Note B.
(b) Includes gain of $843,000 ($473,000 after income taxes — 26 cents per share primary and 16 cents per share fully diluted) from the sale of three DC9 engines. See Note B.
(c) Includes excess insurance proceeds from the loss of a DC9 aircraft which increased net income by $3,922,000 ($2.26 per share primary and $1.41 per share fully diluted). See Note B.
(d) Includes mail revenue of $1,391,000 ($682,000 after income taxes — 39 cents per share primary and 25 cents per share fully diluted) related to the period 1973 through September 30, 1977. See Note B.

Quarterly earnings per share do not total earnings per share for the year because the computation of earnings per share for certain quarters did not include common stock equivalents which were 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 other property and equipment, and has presented 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 other property and equipment at December 31, 1978 and 1977, and the approximate effect which replacement cost would have had on depreciation expense for such years, 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.

Equal Opportunity Policy

It is the policy and practice of Southern Airways, Inc., to recruit, hire, and promote those persons who are best qualified without regard to their race, color, religion, sex, age (40-65), national origin, or physical or mental handicap, and not to discriminate against any employee or applicant for employment because he/she is a disabled veteran or Vietnam era veteran.

To further this objective, the Company has established procedures to insure that all personnel actions such as compensation, benefits, transfers, lay-offs, returns from lay-off, Company sponsored training, education, tuition assistance, social and recreational programs, and all Company facilities are administered without regard to race, color, religion, sex, age (40-65), national origin, physical or mental handicap and will take into consideration those employees who are disabled veterans or Vietnam era veterans.

These practices are designed and implemented to be in concert with the accepted standards and principles of equal opportunity employment.

Five-Year Operating and Financial Summary

SOUTHERN AIRWAYS, INC.

	1978	1977	1976	1975	1974
		(	As Restated – (2)		)
Summary of Operations					
(In thousands, except per share amounts)					
Operating revenues					
Passenger	$ **159,802**	$ 130,828	$ 115,206	$ 95,666	$ 86,821
Charter	**7,162**	9,594	8,803	8,208	6,908
Public Service	**4,327**	5,220	5,723	5,961	6,805
Other	**17,221**	13,869	10,435	8,115	7,818
	188,512	159,511	140,167	117,950	108,352
Operating expenses					
Depreciation and amortization	**12,900**	10,670	9,809	8,287	7,917
Other	**167,906**	139,581	125,756	101,905	91,939
	180,806	150,251	135,565	110,192	99,856
Operating income	**7,706**	9,260	4,602	7,758	8,496
Interest on long-term debt	**6,905**	4,643	4,687	4,755	5,923
Miscellaneous deductions (income)-net	**(2,515)**	(6,606)	(514)	(611)	(623)
Income before income taxes, extraordinary tax credit and accounting change	**3,316**	11,223	429	3,614	3,196
Income taxes	**909**	1,881	104	985	860
Income before extraordinary tax credit and accounting change	**2,407**	9,342	325	2,629	2,336
Tax benefits of net operating loss carryforward	—	—	—	185	800
Cumulative effect of accounting change	—	—	—	—	565
Net income	$ **2,407**	$ 9,342	$ 325	$ 2,814	$ 3,701
Earnings per common and common equivalent share					
Primary	$ **1.29**	$ 5.39	$ .17	$ 1.62	$ 2.33
Fully diluted	$ **.93**	$ 3.45	$ .17	$ 1.16	$ 1.47
Average number of common and common equivalent shares					
Primary	**1,839**	1,733	1,581	1,765	1,599
Fully diluted	**2,888**	2,800	1,581	2,912	2,913
Financial Position—at year end					
(In thousands, except per share amounts)					
Current assets	$ **37,535**	$ 34,932	$ 28,307	$ 30,324	$ 27,214
Current liabilities	**38,680**	37,280	30,154	27,033	26,931
Property and equipment—net	**80,653**	79,234	60,598	57,541	56,182
Long-term debt (excluding current maturities)					
Notes payable and other	**50,300**	50,724	40,138	42,306	42,032
Convertible subordinated debentures	**7,270**	8,289	9,307	9,743	10,178
Total stockholders' equity	**23,676**	19,986	10,762	10,496	7,801
Common stockholders' equity (1)	**23,676**	19,005	9,720	9,454	6,755
Common stockholders' equity per common share	**12.49**	12.02	6.15	5.98	4.28
Common shares outstanding	**1,896**	1,581	1,581	1,581	1,580
Operating Statistics					
Scheduled services					
Passengers carried (thousands)	**4,111**	3,457	3,245	2,935	2,940
Available seat miles (thousands)	**2,449,402**	2,043,061	1,926,166	1,688,633	1,618,776
Revenue passenger miles (thousands)	**1,334,987**	1,044,818	978,991	852,547	832,372
Passenger load factor	**54.5%**	51.1%	50.8%	50.5%	51.4%
Breakeven passenger load factor	**53.2%**	46.2%	50.6%	48.2%	49.1%
Revenue per passenger	$ **38.83**	$ 37.80	$ 35.46	$ 32.55	$ 29.49
Revenue per passenger mile	**12.0¢**	12.5¢	11.7¢	11.2¢	10.4¢
All Services					
Available seat miles (thousands)	**2,625,064**	2,290,839	2,167,198	1,906,443	1,803,177
Cost per seat mile	**6.9¢**	6.6¢	6.3¢	5.8¢	5.5¢
Number of employees at year end	**3,216**	2,922	2,766	2,519	2,639

(1) After deducting equity of preferred stockholders at $6 per outstanding preferred share plus cumulative dividends at the end of each of the years 1974 through 1977. All shares of preferred stock were either converted to common or redeemed as of December 31, 1978. Annual dividends of $.36 per share ($.285 in 1978) have been paid on preferred shares for 1974 through 1978. No cash dividends on common stock have been paid since 1967.

(2) Restated to comply with FASB Statement No. 13, "Accounting for Leases."

Directors and Officers

Directors

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

GEORGE M. GROSS
President
Southern Airways, Inc.

GRAYDON HALL*
Vice-Chairman of the
Board of Directors
Southern Airways, Inc.

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

DAVID H. HUGHES
President and Chief Executive Officer
Hughes Supply, Inc.
(Manufacturer and Distributor of
Electrical and Plumbing Supplies)
Orlando, Florida

FRANK W. HULSE*
Chairman of the Board and
Chief Executive Officer
Southern Airways, Inc.

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

HENRY P. JOHNSTON+
Radio and Television Consultant
Birmingham, Alabama

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Chairman of the Board
The Jordan Company (Construction)
Columbus, Georgia

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

A. L. MAXSON
Vice President-Finance
and Treasurer
Southern Airways, Inc.

G. FRANK PURVIS, JR.**
Chairman of the Board and Chief
Executive Officer-Pan American
Life Insurance Company
New Orleans, Louisiana

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

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

RICHARD A. TRIPPEER, JR.**
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

FRANK M. YOUNG, III**
Partner — North Haskell
Slaughter Young & Lewis
(Attorneys)
Birmingham, Alabama

Officers

FRANK W. HULSE
Chairman and Chief
Executive Officer

GRAYDON HALL
Vice Chairman of the
Board of Directors

GEORGE M. GROSS
President

CECIL A. BEASLEY, JR.
Vice President and
Assistant Secretary

J. KENNETH COURTENAY
Vice President-Economic
Regulations and Secretary

JAMES G. GODSMAN
Vice President-Customer
Sales and Service

A. L. MAXSON
Vice President-Finance
and Treasurer

J. R. PRICE
Vice President-Properties

VICTOR C. PRUITT
Vice President-
Technical Services

T. M. SHANAHAN
Vice President-Flight

THOMAS A. WILEY, JR.
Vice President-
Marketing

RAY W. BURDEN
Assistant Treasurer

GERALD N. COX
Assistant Vice President-
Personnel

J. PHILLIP DAY
Assistant Vice President-
System Planning

W. H. MACKINNON
Assistant Treasurer

WILLIAM E. OAKES
Assistant Vice President-
Economic Research

MARY C. HAYES
Assistant Secretary

Wm. BEW WHITE, JR.
Assistant Secretary

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

General Information

Counsel
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 Int'l Airport
Atlanta, Georgia 30320

Southern

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