MESABA

Mesaba Aviation, Inc.
1987 Annual Report

Corporate Profile

A U.S. Domestic Air Carrier, Mesaba Aviation, Inc. is a regional airline serving the hub airport of Minneapolis/St. Paul, Minnesota. As of June 1987, Mesaba was providing scheduled passenger and air freight service to 21 cities in Minnesota, Iowa, Nebraska, North Dakota, South Dakota and Wisconsin.

Since fiscal 1982, Mesaba's operating revenues have increased at a 69 percent compound annual rate. The airline ranked among the 30 largest regional carriers in the nation by the end of fiscal 1987.

The airline operates as Mesaba/ Northwest Airlink under a marketing agreement with Northwest Airlines. Mesaba's flights carry Northwest's two-letter airline code in the nation's computerized reservations systems. This Airlink relationship also enhances Mesaba's ability to provide convenient service and competitive fares between its regional cities and Northwest's global route system.

Mesaba currently operates a fleet of five 48-passenger Fokker F27 jet props and seven new 19-passenger Metro III jet props.

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

Financial Highlights (In thousands, except per share data)

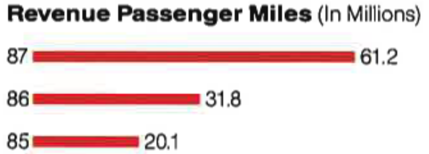
Year Ended March 31	**1987**	1986	1985	1984	1983
Operating revenues	**$21,806**	$13,763	$ 9,244	$ 6,043	$ 4,048
Operating expenses	**22,148**	12,844	8,715	5,274	3,682
Operating income (loss)	**(342)**	919	529	769	366
Income (loss) before extraordinary item	**(213)**	201	165	425	120
Extraordinary item	**—**	—	—	—	68
Net income (loss)	**(213)**	201	165	425	188
Net income (loss) per share	**(.07)**	.08	.07	.19	.14
Weighted average number of shares outstanding	**2,880**	2,538	2,267	2,268	1,345

Operating Statistics

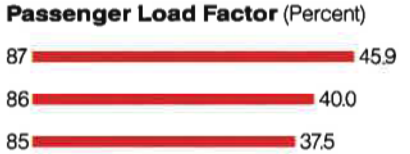
Year Ended March 31	**1987**	1986	1985	1984	1983
Revenue passengers carried	**292,457**	152,087	92,736	56,534	31,720
Revenue passenger-miles (000)	**61,172**	31,815	20,097	10,572	5,572
Available seat-miles (000)	**133,414**	79,462	53,613	29,163	16,581
Passenger load factor	**45.9%**	40.0%	37.5%	36.3%	33.6%
Yield per revenue passenger-mile	**32.6¢**	34.8¢	30.4¢	29.7¢	30.6¢
Operating costs per available seat-mile	**16.3¢**	15.7¢	15.7¢	16.7¢	18.8¢
Departures	**30,194**	26,851	24,398	19,506	12,974

Operating Revenues (Dollars in Millions)

Revenue Passenger Miles (In Millions)



Passenger Load Factor (Percent)



To Our Shareholders

Fiscal 1987 was a year of significant and measurable progress for Mesaba. By dealing effectively with competitive industry conditions, we overcame our first half difficulties and returned to profitability in the third and fourth quarters. Though disappointed by our net loss for the entire year, we are encouraged by Mesaba's strong turnaround and believe the necessary foundation for future profitable growth has been securely established.

The true significance of fiscal 1987 becomes fully apparent when it is separated into two distinct periods.

Due to weak yields and lower passenger load factors resulting from intense competition, Mesaba posted a net loss of $640,000 for the first six months of the year.

However, for the second half of fiscal 1987, Mesaba reported net income of $427,000 due to the surge of traffic growth and high load factors generated by our system realignment that took effect on October 1, 1986.

For the year ended March 31, 1987, Mesaba reported a net loss of $213,000 or 7 cents per share, compared to net income of $201,000 or 8 cents per share in fiscal 1986. Operating revenues, however, rose 58 percent in fiscal 1987 to $21.8 million from $13.8 million a year ago. Mesaba's revenues have increased at a 69 percent five-year compound rate, and we now rank among the 30 largest regional carriers out of approximately 175 in the United States.

Successfully Adapting to Difficult Industry Conditions

Since lower yields and load factors were taking a toll on our results during the first half of fiscal 1987, it became necessary to develop new operating strategies designed to better adapt Mesaba to the difficult conditions affecting the airline industry. Following the acquisition of Republic Airlines by Northwest Airlines on October 1, 1986, the realignment of our route system was one of the important actions we took in conjunction with the new Northwest, our Airlink partner. As reflected by Mesaba's second half turnaround, this system restructuring is enabling Mesaba to grow profitably as a high volume carrier within a low-yield environment. Our new route system has further strengthened Mesaba's position as the dominant provider of regional air service to and from Minneapolis/St. Paul by expanding our share of regional traffic.

The results of Mesaba's improved competitive position are evident in several key operating statistics.
— Revenue passenger miles rose 92 percent in fiscal 1987 to 61.2 million.
— Passenger load factors averaged 45.9 percent for the year, compared to 40.0 percent in fiscal 1986. Equally significant, our load factor during the second half of fiscal 1987 rose to 50.0 percent from 41.8 percent during the first six months of the year. The substantial traffic growth that Mesaba recorded during the third and fourth quarters fueled Mesaba's return to profitability in the second half. We believe our high-volume operating strategy will continue to serve us well as we look ahead to fiscal 1988.

An Excellent Fleet and Effective Airlink Relationship

Our future performance will also benefit from a number of other factors.

First, we have developed an excellent, modern fleet that is well matched to the service requirements of our regional markets. Our Fokker F27s and the new Metro III jet prop fleet, introduced earlier in 1986, have given Mesaba substantial flexibility in matching aircraft types to varying market needs and route densities. Our fleet also provides us with a high degree of operational reliability and passenger comfort. These aircraft types are the two most popular aircraft in the regional airline industry.

A second positive factor is Mesaba's Airlink relationship with Northwest. Our Airlink partner accounts for more than 75 percent of daily scheduled major carrier operations at our Minneapolis/St. Paul hub. Few, if any, other major airlines hold such a dominant position at one hub, and Mesaba is a beneficiary of Northwest's strong market presence. We are providing convenient service and competitive fares to increasing numbers of passengers between our regional cities and Northwest's worldwide route system.

Our marketing relationship with Northwest is also having a favorable impact on Mesaba's cost structure by reducing expenses in certain areas. Under the terms of our Airlink agreement, Northwest has assumed most of our reservations functions, a variety of marketing programs, and certain ground service operations in cities where we provide complementary service and supplement Northwest's scheduled service.

Looking Ahead to Fiscal 1988

Based upon the competitive strength of our route system, we believe that fiscal 1988 will be a substantially improved year for Mesaba. This outlook is borne out by initial passenger data from the first two months of fiscal 1988, which indicates that our traffic growth is remaining strong. Systemwide passenger load factors of 57.6 percent and 57.7 percent for April and May 1987 are among the highest in our industry.

We can accommodate strong passenger and revenue growth this year without adding much new equipment. By being able to avoid the high costs associated with major aircraft purchases and introductions, we are concentrating on strengthening our profitability and cash flow, which is a top priority in fiscal 1988.

We are continuing to evaluate potential new markets for Mesaba and stand ready to take advantage of any reasonable growth opportunities that could arise during the year, and we believe that our growth will continue to be strong over the next few years.

Our improving future prospects are also based on the exceptional quality of Mesaba's service, and for this we thank the dedicated efforts of our many fine employees. We also appreciate the continuing support of our shareholders and look forward to rewarding your confidence with positive news throughout fiscal 1988.

Sincerely,

Robert D. Swenson
President and
Chief Executive Officer

Developing One of The Industry's Strongest Regional Systems

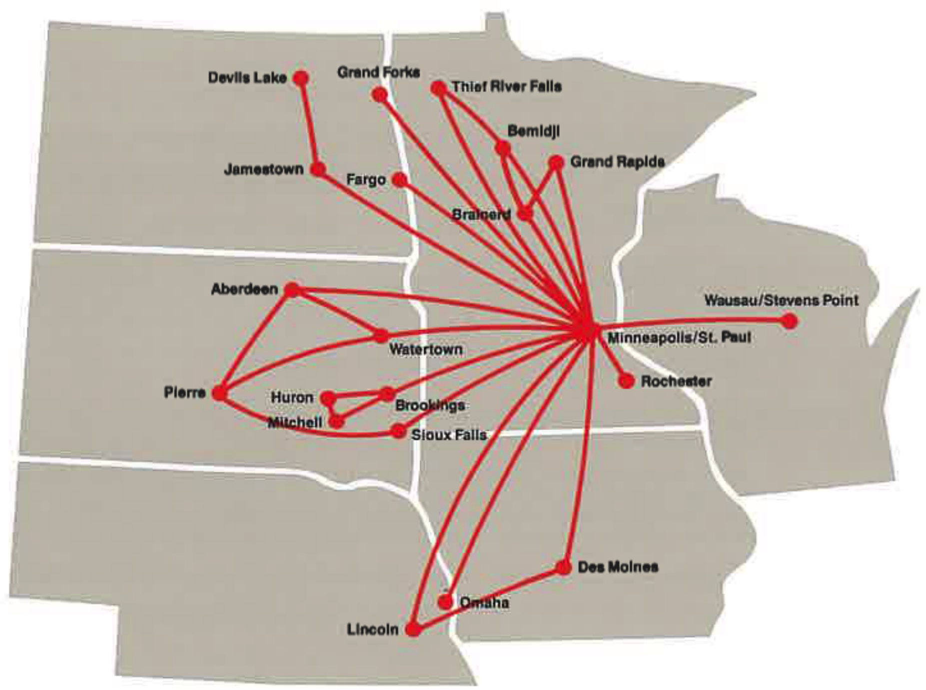
Mesaba has established a position as one of the fastest growing U.S. airlines over the past five years. Although unsettled industry conditions have caused earnings to fluctuate during this growth process, we are confident that Mesaba can now begin to achieve greater stability and enhanced profitability due to efforts aimed at further strengthening and refining our regional route system.

The operating strategies that were implemented in fiscal 1987 are helping Mesaba take maximum advantage of the basic underlying strengths of our multi-state system spanning the Upper Midwest. Nearly all passenger traffic in this region uses Minneapolis/St. Paul for connections to the rest of the country and overseas. Since this region has no other competing hub airport, Mesaba has been free to concentrate on developing the full potential of regional air service to and from Minneapolis/St. Paul.

An Effective Airlink Relationship with Northwest

We not only focus our operations on the region's only major hub airport, Mesaba also has an excellent marketing relationship with the dominant major carrier at Minneapolis/St. Paul, Northwest Airlines. By coordinating our schedules and sharing Northwest's flight designator code in computerized reservations systems, this relationship has greatly enhanced Mesaba's regional presence and market visibility. In effect, we are providing an efficient, convenient and competitive "Airlink" between our regional communities and Northwest's network of destinations on three continents.

Mesaba Route System June 1, 1987



Philip L. Swenson (left), Vice President–Planning and Marketing, and Kenneth P. Bronson, Vice President-Finance and Treasurer, at Mesaba's gate facilities on the Gold Concourse of Minneapolis/St. Paul International Airport.

The acquisition of Republic by Northwest in 1986 made it necessary to better reallocate our resources in this region. The net result of the system realignment is that Mesaba is now the largest regional carrier in all of our markets. Equally important, these are strong markets, capable of sustaining good traffic volumes on a year-round basis.

Our strengthened competitive position is reflected by Mesaba's ranking as both the dominant regional airline and fifth largest carrier overall serving Minneapolis/St. Paul in terms of passenger boardings during April 1987. The substantial improvements that have been made over the past year make us feel that Mesaba now has one of the strongest regional route systems in the country.

This system restructuring is also permitting Mesaba to operate profitably as a high volume or high traffic carrier amid an intensely competitive industry environment. The substantially higher traffic and load factors that Mesaba has recorded since the new system took effect have more than compensated for low yields. This strategy enabled Mesaba to register both strong growth and good profitability over the second half of fiscal 1987. We are confident that this same formula will continue to drive Mesaba's turnaround in fiscal 1988.

A Wide Range of Future Growth Opportunities

In addition to further strengthening our overall competitive position, Mesaba's realigned route system also provides us with numerous opportunities for continued future growth.

For example, Mesaba has Northwest Airlink service rights in Minnesota, South Dakota, North Dakota and Nebraska. This means that we can start up service to new markets of our choice as well as increase service frequencies in existing markets within these states that are not already served by another Airlink carrier. In addition, we have growth opportunities in several other markets, including Wisconsin and Illinois.

Even without adding any new markets or aircraft in fiscal 1988, Mesaba will be able to record excellent growth due to the basic strength of our route system. Based upon current operations, Mesaba could carry approximately 30 percent more passengers in fiscal 1988 with the same aircraft, equipment utilization and markets as at the end of fiscal 1987. So even without any expansion during the coming year, Mesaba would still rank as one of the fastest growing carriers in the country.

We are continuing to evaluate new service to additional selected markets and expect to be reporting market introductions during the coming year. We have some flexibility with our existing fleet of fast and efficient 48-passenger Fokker F27s and 19-passenger Metro IIIs to accommodate some additional expansion moves that could develop in fiscal 1988.

Standing, left to right, with passengers deplaning from a Fokker F27 jet prop: Lawrence E. McCabe, Vice President–Airline Operations; Michael R. Wind, Vice President–Ground and In-Flight services; Richard A. Lawrence, Vice President-Flight Operations; and, James L. Haarbauer, Vice President-Maintenance and Engineering.

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

Earnings Summary

The Company reported a net loss of $213,000 or 7 cents per share in fiscal 1987, reflecting the severe impact of diminished yield and passenger load factors experienced during the first half of fiscal 1987. Following the merger of Northwest Airlines with Republic Airlines effective October 1, 1986, the Company moved to realign its route structure and revise its Airlink agreement with the new Northwest. Under these new arrangements, the Company's operating performance improved significantly as reflected by the $427,000 of net income earned in the second half of fiscal 1987. The improved revenue and passenger load factors realized under the new route alignment and Airlink arrangements are continuing. The above results compare to net income of $201,000 or 8 cents per share in 1986 and $165,000 or 7 cents per share in 1985.

Results of Operations

Operating revenues. Operating revenues totaled $21,806,000 in fiscal 1987, an increase of 58 percent from $13,763,000 in 1986 and also up from $9,244,000 in 1985. The 1987 increase resulted principally from strong growth in passenger revenues, attributable to the Company's realigned route system, additional fleet capacity and the positive impact on traffic growth of the Airlink marketing agreement with Northwest Airlines. As a percentage of total operating revenues, public service revenues declined to 5 percent in fiscal 1987 from 15 percent in 1986 and 27 percent in 1985.

The Company's yield per revenue passenger mile was 32.6 cents in fiscal 1987, compared to 34.8 cents in 1986 and 30.4 cents in 1985. Reflecting competitive pressures throughout the airline industry, the lower yield in 1987 was partially offset by strong passenger traffic growth, particularly during the second half of the year. For the full year, revenue passenger miles rose 92 percent to 61,172,000 from 31,815,000 in 1986 and was also up from 20,097,000 in 1985. Available seat miles increased at a slower rate in fiscal 1987, resulting in a passenger load factor of 45.9 percent for the year, up from 40.0 percent to 1986 and 37.5 percent in 1985.

Operating expenses. Due primarily to substantial fleet capacity expansion in fiscal 1987, total operating expenses rose 72 percent to $22,148,000 from $12,845,000 in 1986 and were also up from $8,715,000 in 1985. Operating costs per available seat mile rose to 16.3 cents in fiscal 1987 from 15.7 cents in both fiscal years 1986 and 1985. Management believes that operating costs per available seat mile should stabilize in fiscal 1988.

Flight operations expenses increased 95 percent in fiscal 1987 from 1986 and were also up from 1985, due largely to the increased leasing costs and other expenses associated with the introduction of seven new Metro III jet prop aircraft, which replaced five previously-owned and one leased Beech 99 aircraft. Aggregate annual lease expense under the 12-year operating lease arrangements for the Metro III aircraft totals $2,406,000 per year. In addition, fiscal 1987 was the first full year that operating leases were in effect for two Fokker F27 aircraft placed into service in fiscal 1986. These leases have six-year terms with an aggregate annual lease expense of $1,140,000.

Maintenance costs rose 118 percent in fiscal 1987, partially reflecting the greater number of leased aircraft. In accordance with the maintenance schedule of its lease agreements, the Company accrued $1,295,000 in fiscal 1987 for future aircraft overhauls on an hours-flown basis. The increase also reflects greater material and manpower requirements associated with expanded fleet capacity and related service requirements.

Aircraft and traffic servicing expenses increased 72 percent in fiscal 1987, attributable to the higher level of flight operations supporting increased passenger traffic. Ground and in-flight personnel were added to accommodate this higher volume of business, while other significant expenses, such as landing fees and terminal charges, also rose accordingly.

Notwithstanding the significant increases in revenues and passenger volume, reservations, sales and advertising expenses in 1987 were essentially unchanged from the year-earlier level, reflecting the positive impact of the Company's Airlink agreement with Northwest Airlines. Under terms of this revised agreement, Northwest Airlines has assumed substantially all reservation and advertising functions for the Company, which resulted in lower expenses in these areas in the latter portion of the fiscal year. Management anticipates further savings in fiscal 1988, primarily in marketing and advertising costs.

Depreciation and amortization expense increased slightly over prior year levels as the Company's decision to meet equipment needs through operating lease arrangements has allowed the Company to reduce its fixed investment.

General and administrative expenses increased 52 percent in fiscal 1987 due principally to higher personnel costs needed to accomodate the Company's expanded route system and volume of business.

Nonoperating expense (income). The Company incurred net nonoperating expense of $133,000 in fiscal 1987, compared to $478,000 in 1986 and $262,000 in 1985. The fiscal 1987 decline in net nonoperating expense resulted principally from the gain of $287,000 realized from the sale of five Beech 99 aircraft.

(Benefit) provision for income taxes. Reflecting the operating loss for the year, the Company realized an income tax benefit of $262,000 in fiscal 1987, compared to tax expense of $239,000 and $102,000 in fiscal 1986 and fiscal 1985, respectively.

Financial Condition

Net cash flow provided from operations was $1,773,000 for the 1987 fiscal year, compared to $1,779,000 in fiscal 1986 and $1,188,000 for fiscal 1985. Cash and short-term investments rose by $1,529,000 to $2,080,000 at March 31, 1987 and were provided primarily from operations and the sale of five Beech 99 aircraft in April and May of 1986 for $1,678,500. Significant funds were provided from issuance of debt in 1985 and from both the issuance of debt and $1,996,000 related to the issuance of common stock and warrants in 1986. These funds were used principally for the purchase of property and equipment during these periods. During 1987 financing activities resulted in a net reduction in funds of $39,000 as a result of the repayment of debt. Funds used for investing activities declined significantly as the Company has moved to meet its equipment needs principally through operating lease arrangements. The Company's current ratio declined slightly to 1.28 at March 31, 1987 from 1.39 at March 31, 1986.

The airline industry is both capital and labor intensive. To date, the Company has relied largely upon borrowings, internally-generated funds and the sale of common stock to fund its capital requirements. Over the years, the Company has made substantial long-term investments in additional aircraft and related parts and equipment which reduce working capital. As described above, the Company is currently leasing substantially all of its aircraft under operating lease arrangements ranging from 6 to 12-year terms.

The Company has available two bank lines of credit totaling $1,050,000, with interest payable at approximately the prime rate. These bank lines are collateralized by certain equipment, inventories and accounts receivable.

Total long-term debt, including current maturities, decreased to $5,439,000 at March 31, 1987 from $5,674,000 a year earlier. The Company made long-term debt repayments of $1,242,000 during fiscal 1987. The Company incurred additional borrowings of $1,007,000, which were associated principally with financing equipment for new Metro aircraft and related spare parts.

In June 1985, the Company entered into a Debenture Purchase Agreement for $2,500,000 with Northwest Aircraft Inc., a wholly-owned subsidiary of NWA Inc. The debentures are convertible into the Company's common stock at the rate of $3.96 per share. The proceeds received from the issuance of the debentures were used to purchase a Fokker F27 aircraft and related parts and equipment.

Stockholders' equity at March 31, 1987 was $5,197,000, compared to $5,213,000 at March 31, 1986. The ratio of long-term debt (including current maturities) to stockholders equity improved slightly to 1.05 at March 31, 1987 from 1.09 a year earlier.

In June 1987, the Company was finalizing a ground lease with the Metropolitan Airports Commission for a site located at Minneapolis/St. Paul International Airport. The Company intends to use the land for the construction of a new hangar, shop and general office facility, which is expected to be completed during fiscal 1988. The ground lease provides for an annual lease rate of $144,000 over a 25-year term. The Company is currently pursuing various financing alternatives for the facility, which is estimated to cost $4,000,000.

Effect of Inflation

The Company's operating costs, particularly labor, are subject to general economic and inflationary pressures. While labor costs have increased during each of the past three years, the Company does not believe that its results of operations have been significantly affected by inflation. Competition in the airline industry may limit the Company's ability to pass on increased costs through fare increases.

Effect of The Tax Reform Act of 1986

The Tax Reform Act of 1986 reduced corporate income tax rates and also eliminated the investment tax credit effective January 1, 1986. Accordingly, the tax benefits the Company has received related to investment tax credits are no longer available. The remaining provisions of the Act which are expected to impact the Company generally become effective in fiscal 1988. Although the complexity of this Act makes it difficult to quantify the impact of these changes, management believes that the Company's results of operations, financial condition and liquidity will not be significantly affected.

Balance Sheets

	March 31 1987	March 31 1986
Assets		
Current Assets:		
Cash and short-term investments	$ 2,080,089	$ 550,728
Accounts receivable	2,479,615	1,759,575
Inventories	731,079	587,449
Net assets held for sale (Note 2)	—	1,348,717
Prepaid expenses and deposits	273,504	414,996
Total current assets	5,564,287	4,661,465
Property and Equipment (Notes 2 and 3):		
Flight equipment	9,529,062	8,101,908
Other property and equipment	2,065,185	1,819,787
Accumulated depreciation and amortization	(2,550,263)	(1,214,796)
Net property and equipment	9,043,984	8,706,899
Other Assets, principally deferred preoperating costs, net of accumulated amortization of $373,000 and $336,000, respectively	302,387	494,335
	$14,910,658	$13,862,699
Liabilities and Stockholders' Equity		
Current Liabilities:		
Current maturities of long-term debt	$ 1,711,556	$ 1,325,752
Accounts payable	1,489,860	1,259,699
Accrued liabilities—		
Payroll	331,150	304,002
Maintenance	236,763	96,035
Property taxes	239,882	94,452
Other	347,731	269,067
Total current liabilities	4,356,942	3,349,007
Long-Term Debt, net of current maturities (Note 4)	3,727,465	4,348,298
Other Noncurrent Liabilities, principally accrued maintenance (Note 2)	1,195,630	256,047
Deferred Income Taxes	434,000	696,400
Commitments and Contingencies (Note 6)		
Stockholders' Equity:		
Common stock, $0.01 par value; 5,000,000 shares authorized, 2,941,827 and 2,851,111 shares issued and outstanding, respectively	29,418	28,511
Paid-in capital	4,352,109	4,270,815
Warrants issued for 234,539 and 120,495 common shares, respectively (Note 8)	225,789	111,745
Retained earnings	589,305	801,876
Total stockholders' equity	5,196,621	5,212,947
	$14,910,658	$13,862,699

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

Statements of Operations

	Years Ended March 31 1987	1986	1985
Operating Revenues:			
Passenger	$19,914,990	$11,071,566	$6,102,511
Public service	1,192,443	2,070,179	2,514,785
General aviation, freight and charter	698,988	621,482	626,512
Total operating revenues	21,806,421	13,763,227	9,243,808
Operating Expenses:			
Flight operations	8,767,275	4,503,087	3,179,799
Maintenance	4,666,615	2,138,657	1,371,155
Aircraft and traffic servicing	4,265,761	2,475,496	1,635,757
Reservations, sales and advertising	1,157,919	1,112,582	809,999
General and administrative	1,660,149	1,089,629	723,785
Depreciation and amortization	1,630,379	1,525,107	994,805
Total operating expenses	22,148,098	12,844,558	8,715,300
Operating (loss) income	(341,677)	918,669	528,508
Nonoperating Expense (Income):			
Interest expense	477,500	466,566	394,323
Other, net (Note 2)	(344,606)	11,786	(132,795)
Net nonoperating expense	132,894	478,352	261,528
(Loss) income before income taxes	(474,571)	440,317	266,980
(Benefit) Provision for Income Taxes	(262,000)	239,000	102,000
Net (loss) income	$ (212,571)	$ 201,317	$ 164,980
Net (Loss) Income per Share	$ (0.07)	$ 0.08	$ 0.07
Weighted Average Shares Outstanding (Note 3)	2,880,210	2,537,971	2,266,627

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

Statements of Changes in Stockholders' Equity

for the years ended March 31, 1987, 1986, 1985

	Common Stock Shares	Common Stock Amount	Paid-In Capital	Warrants Shares	Warrants Amount	Retained Earnings	Total Stockholders' Equity
Balance, March 31, 1984	2,107,604	$21,076	$2,370,096	—	$ —	$435,579	$2,826,751
Exercise of stock options	15,205	152	10,749	—	—	—	10,901
Issuance of stock bonuses	4,730	47	12,960	—	—	—	13,007
Net income	—	—	—	—	—	164,980	164,980
Balance, March 31, 1985	2,127,539	21,275	2,393,805	—	—	600,559	3,015,639
Sale of common stock, net of offering costs and commissions	700,000	7,000	1,850,347	35,000	26,250	—	1,883,597
Exercise of stock options	20,406	204	14,425	—	—	—	14,629
Issuance of stock bonuses	3,166	32	12,238	—	—	—	12,270
Issuance of warrants	—	—	—	85,495	85,495	—	85,495
Net income	—	—	—	—	—	201,317	201,317
Balance, March 31, 1986	2,851,111	28,511	4,270,815	120,495	111,745	801,876	5,212,947
Exercise of stock options	87,366	874	69,168	—	—	—	70,042
Issuance of stock bonuses	3,350	33	12,126	—	—	—	12,159
Issuance of warrants	—	—	—	114,044	114,044	—	114,044
Net loss	—	—	—	—	—	(212,571)	(212,571)
Balance, March 31, 1987	2,941,827	$29,418	$4,352,109	234,539	$225,789	$589,305	$5,196,621

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

Statements of Changes in Financial Position

	Years ended March 31 1987	1986	1985
Operating Activities:			
Operations—			
Net (loss) income	$ (212,571)	$ 201,317	$ 164,980
Items not requiring cash:			
Depreciation and amortization	1,630,379	1,525,107	994,805
Accrued long-term maintenance	1,004,929	—	—
Deferred income taxes	(262,000)	239,000	102,000
Gain on sale of commuter aircraft (Note 2)	(287,418)	—	—
Cash flow from operations before changes in current operating items	1,873,319	1,965,424	1,261,785
Changes in current operating items—			
Accounts receivable	(720,040)	(877,829)	4,391
Inventories	(143,630)	(181,288)	(15,973)
Prepaid expenses	141,492	(360,349)	(41,379)
Accounts payable and accrued liabilities	622,131	1,232,855	(20,341)
Net cash flow provided by operating activities	1,773,272	1,778,813	1,188,483
Financing Activities:			
Issuance of common stock and warrants	196,245	1,995,991	23,908
Issuance of debt	1,007,383	2,692,927	2,033,000
Payment of debt	(1,242,418)	(1,433,592)	(693,954)
Net cash provided by (used for) financing activities	(38,790)	3,255,326	1,362,954
Investing Activities:			
Purchases of property and equipment, net	(1,754,992)	(4,888,342)	(3,159,763)
Proceeds from commuter aircraft sold (Note 2)	1,678,500	—	—
Changes in other noncurrent liabilities	(65,346)	231,422	—
Changes in other assets	(63,283)	(183,086)	(291,696)
Net cash used for investing activities	(205,121)	(4,840,006)	(3,451,459)
Increase (Decrease) in Cash and Short-Term Investments	1,529,361	194,133	(900,022)
Cash and Short-Term Investments:			
Beginning of year	550,728	356,595	1,256,617
End of year	$2,080,089	$ 550,728	$ 356,595

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

Notes to Financial Statements

Note 1—Business

Mesaba Aviation, Inc. (Mesaba) is a regional air carrier providing scheduled passenger and air freight service to 21 cities in the Upper Midwest. Effective December 1, 1984, Mesaba began operating as Mesaba/Northwest Orient Airlink under a five year marketing agreement with Northwest Airlines, Inc. (Northwest). As part of this agreement, all flights are designated as Northwest flights, all flights appear in Northwest's timetables and Mesaba receives ticketing and certain check-in, baggage and freight handling services from Northwest at certain airports. Mesaba also benefits from its relationship with Northwest through prorated fare arrangements, advertising and marketing programs. In addition, Northwest has provided certain aircraft financing for Mesaba (see Notes 4 and 8). Approximately 65%, 51% and 26% of Mesaba's passengers connected with Northwest in fiscal 1987, 1986 and 1985, respectively.

Following the completion of the merger of Northwest with Republic Airlines, Inc. (Republic) effective October 1, 1986, Mesaba amended its marketing agreement with Northwest providing for a realignment of its route structure, modifications in the proration of fare revenues and arrangements for certain terminal facilities. In addition, the amended agreement states that Northwest is to assume substantially all reservation and advertising functions. A portion of these expenses were previously borne by Mesaba.

Note 2—Flight Equipment

Mesaba's fleet consisted of the following aircraft as of March 31, 1987:

Number of Aircraft	Type of Aircraft	Seating Capacity
7	Fairchild Metro III (Metro)	19
5	Fokker F-27 (F-27)	44-48

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

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

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

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

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

Note 3—Summary of Significant Accounting Policies

Short-Term Investments:
Short-term investments consist of commercial paper stated at cost, which approximates market.

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

Property and Equipment:
Property and equipment is stated at cost and depreciated on a straight-line basis for financial reporting purposes over estimated useful lives of 7-10 years for aircraft engines, flight equipment and rotable parts; 3-10 years for all other equipment; and 5-36 years for buildings and improvements. Leasehold improvements are amortized over the shorter of the life of the lease or the life of the asset. Accelerated cost recovery methods of depreciation are applied for tax reporting purposes.

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

The costs of developing new or extended routes and related preoperating costs are deferred and amortized over two years.

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

Income Per Share:
Net income per share has been computed based upon the weighted average number of common and equivalent shares outstanding during each year. The equivalent shares include the net additional shares which would be issuable upon the exercise of stock options and warrants assuming repurchase of common shares with the related proceeds.

Reclassification:
Certain 1986 and 1985 amounts have been reclassified to conform with the 1987 presentation. These reclassifications had no effect on net income or stockholders' equity as previously reported.

Note 4—Debt

Mesaba has demand line-of-credit agreements with two banks under which it may borrow up to $1,050,000 at approximately the prime interest rate. Borrowings are collateralized by inventory, accounts receivable and certain equipment. A summary of short-term borrowing activities is as follows:

Years ended March 31	1987	1986	1985
Balance at year end	$ —	$ —	$ —
Maximum borrowings	925,000	807,000	175,000
Average daily borrowings	244,000	172,000	9,300
Average interest rate	8.2%	9.5%	11.0%

Long-term debt is summarized as follows:

	1987	1986
Revolving credit and term loan agreement with a bank; variable interest rate up to prime plus 1.375% (8.875% at March 31, 1987); due in varying quarterly principal installments through June 1989, plus monthly interest payments; collateralized by aircraft, parts and equipment	$1,860,000	$2,420,000
Convertible debentures issued to Northwest Aircraft, Inc. an affiliate of Northwest; interest rate of 9%; due in varying semiannual installments through November 1991; convertible into common stock at the rate of one share for each $3.96 of principal; collateralized by aircraft and parts	2,451,475	2,245,503
Note payable to Fairchild; interest rate of 9%; due in equal monthly installments of $50,000, including interest, from April 1987 through March 1988; collateralized by aircraft engines	554,914	261,356
Note payable to Fairchild; interest rate of 7.5%; due in equal monthly installments of $21,875, including interest, through February 1989; collateralized by parts and equipment	467,279	—
Notes payable; paid in full in April 1986	—	509,298
Other	105,353	237,893
	5,439,021	5,674,050
Less—Current maturities	(1,711,556)	(1,325,752)
Total long-term debt	$3,727,465	$4,348,298

The financing agreements require Mesaba to maintain minimum levels of tangible net worth, net working capital and certain other financial ratios. The agreements also restrict the amount of additional debt Mesaba can issue and require the retention of present management and ownership control. Mesaba has complied with, or obtained amendments to place it in compliance with, these requirements as of March 31, 1987.

During 1986, Mesaba converted its note payable to a bank into a revolving credit and term loan agreement whereby Mesaba could prepay and subsequently borrow up to $1,370,000. The amount available under the revolving portion of this agreement is reduced over the term of the agreement, such that the commitment totals $810,000 at March 31, 1987 and declines quarterly to $360,000 at December 31, 1987, at which time the remaining balance is due.

As of March 31, 1987, the portion of long-term debt due in the five subsequent fiscal years is as follows:

1988	$1,711,556
1989	1,156,182
1990	857,075
1991	249,999
1992	1,324,227
Thereafter	139,982

Note 5—Income Taxes

Mesaba provides deferred taxes for all timing differences between financial and income tax reporting. The (benefit) provision for income taxes for the three years ended March 31, 1987 is comprised of the following elements:

	1987	1986	1985
Current:	$ —	$ —	$ —
Deferred:			
Accelerated depreciation	489,000	518,000	374,000
Deferred preoperating costs	(96,000)	73,000	239,000
Deferred maintenance costs	(551,000)	419,000	48,000
Tax over book gain on sale of fixed assets	(550,000)	—	—
Accrued expenses not deductible for tax reporting purposes	215,000	(63,000)	(14,000)
Deferred tax effects of tax operating loss carryforwards	257,000	(671,000)	(525,000)
Amortization of investment tax credits not realized for tax reporting purposes	(26,000)	(37,000)	(20,000)
Total (benefit) provision for income taxes	$(262,000)	$239,000	$102,000

The difference between the statutory federal income tax rate and the effective tax rate for the three years ended March 31, 1987 is as follows:

	1987	1986	1985
Statutory federal tax rate	(46.0)%	46.0%	46.0%
State taxes, net of federal effect	(5.3)	5.2	5.1
Amortization of deferred investment tax credits	(5.5)	(8.4)	(7.6)
Additional federal provision required and other	1.6	11.5	(5.3)
Effective tax rate	(55.2)%	54.3%	38.2%

At March 31, 1987, Mesaba had net operating loss carryforwards of approximately $2,199,000 and investment tax credit carryforwards of approximately $140,000 for federal tax reporting purposes. These carryforwards expire in varying amounts from 1997 through 2001 and are available to offset future taxes payable.

In 1986, tax legislation was enacted which, among other matters, provided for a reduction of corporate federal income tax rates from 46% in 1986 to 40% in 1987 and 34% thereafter and the elimination of investment tax credits effective January 1, 1986. The Company's investment tax credit carryforwards may be used to offset future tax liabilities; however, any unused carryforward is reduced by 35% effective June 1, 1987. In addition, the Financial Accounting Standards Board has issued an exposure draft of a proposed statement on accounting for income taxes. The combined effect on the Company's financial position and future results of operations of tax legislation and proposed changes in accounting for income taxes is not precisely determinable.

Note 6—Commitments and Contingencies

Litigation:

During 1986, Republic asserted a claim against Mesaba alleging breach of a marketing and equipment lease agreement. Following the completion of the merger of Republic with Northwest all proceedings concerning this matter were terminated.

Commitments:

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

1988	$ 3,774,000
1989	3,774,000
1990	3,602,000
1991	3,556,000
1992	3,319,000
Thereafter	15,166,000

Rent expense under all operating leases totaled approximately $3,614,000 in 1987, $567,000 in 1986 and $371,000 in 1985.

Note 7—Transactions with Related Parties

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

Note 8—Capital Stock

Mesaba has stock option plans for key employees and directors which authorize the issuance of up to 525,000 shares of common stock for such options. Under the plans, options are granted by the compensation committee of the board of directors and are exercisable for five years commencing one year after the date of grant. The purchase price of the stock is 110% of the fair market value of the stock at the date of grant for participants owning 10% or more of the outstanding common stock and 100% of the fair market value for all other participants.

Stock option transactions for the two years ended March 31, 1987 were as follows:

	Shares Under Option
Options outstanding, March 31, 1985	
($0.72 to $3.96 per share)	240,996
Granted ($2.88 to $4.25 per share)	94,000
Exercised ($0.72 per share)	(20,406)
Options outstanding, March 31, 1986	
($0.72 to $4.25 per share)	314,590
Granted ($2.88 to $5.00 per share)	63,000
Exercised ($0.72 to $2.00 per share)	(87,366)
Options cancelled	(17,000)
Options outstanding, March 31, 1987	
($0.72 to $5.00 per share)	273,224

Mesaba has an employee stock purchase plan which allows all full-time personnel employed by Mesaba for more than six months the opportunity to purchase shares of stock in Mesaba at the market price through payroll deductions. All administrative costs of this plan are paid by Mesaba.

Mesaba issued warrants to the underwriter involved with its 1986 stock offering. These warrants allow for the purchase of 35,000 shares of Mesaba's common stock at $3.90 per share and are exercisable any time through November 20, 1990.

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

Auditors' Report

To the Shareholders of Mesaba Aviation, Inc.:

We have examined the balance sheets of MESABA AVIATION, INC. (a Minnesota corporation) as of March 31, 1987 and 1986 and the related statements of operations, changes in stockholders' equity and changes in financial position for each of the three years in the period ended March 31, 1987. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the financial statements referred to above present fairly the financial position of Mesaba Aviation, Inc. as of March 31, 1987 and 1986 and the results of its operations and the changes in its financial position for each of the three years in the period ended March 31, 1987, in conformity with generally accepted accounting principles applied on a consistent basis.

Arthur Andersen & Co.

Minneapolis, Minnesota,
May 15, 1987.

Common Stock Information

The common stock of Mesaba Aviation, Inc. is traded on the NASDAQ National Market System under the symbol MESA. The following table sets forth the high and low bids or last sale price of the Company's common stock for the fiscal quarters of 1987 and 1986.

	Fiscal Years 1987		Fiscal Years 1986	
	high	low	high	low
First quarter	5¾	3⅞	3⅞	2⅝
Second quarter	4⅜	2¾	5	3⅝
Third quarter	3⅞	2⅝	4	2¾
Fourth quarter	4⅞	2⅞	6	2¾

On June 8, 1987, the number of holders of record of common stock was 1,100. No cash dividends have been paid by the Company to date.

Board of Directors

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

Mervin D. Prestebak
Director-Ground Support Services
Mesaba Aviation, Inc.

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

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

Rodger T. Munt 1,3
Senior Vice President-Marketing
Fairchild Aircraft Corporation

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

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

Earl W. Dagg 2
Medical Doctor

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

Corporate Officers

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

Kenneth P. Bronson
Vice President-Finance and Treasurer

J. L. Haarbauer
Vice President-Maintenance
and Engineering

Lawrence E. McCabe
Vice President-Airline Operations

Richard A. Lawrence
Vice President-Flight Operations

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

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

Corporate Information

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

Corporate Counsel
Halpern & Druck
Minneapolis, Minnesota

Auditors
Arthur Andersen & Co.
Minneapolis, Minnesota

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

Notice of Annual Meeting
The annual meeting will be held on Thursday, July 30, 1987 at 3:30 p.m. at the Minneapolis Marriott City Center, 30 South Seventh Street, Minneapolis, Minnesota.

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