SOUTHWEST AIRLINES

ANNUAL REPORT 1971


SOUTHWEST

ABOUT SOUTHWEST AIRLINES

Southwest Airlines is a Texas-based intrastate passenger carrier offering high frequency jet commuter service between the state's three largest metropolitan areas.

Founded in 1967, Southwest inaugurated service in 1971 after a protracted legal battle with competitive carriers in the market. Utilizing four 737 jet aircraft, the carrier features commuter-oriented service, including no-reservation "instant ticketing" and on-board auto rental. Southwest has received national recognition of its unique "love" theme of marketing and its staff of beautiful hot-pants-clad hostesses.

CLOSE-IN DALLAS FACILITIES

Public opinion surveys and other studies conducted by the Company, together with the enthusiastic reception by the travelling public of Southwest's inauguration of its air service into Houston's downtown William P. Hobby airport, have convinced Management that every effort should be exerted to continue the Company's operations at Dallas Love Field after the opening of the outlying Dallas-Fort Worth Regional Airport, now scheduled for late 1973. The Concurrent Bond Ordinance of the Cities of Dallas and Fort Worth provides for the phaseout of Certificated Air Carrier Services at Love Field and their transfer to the Regional Airport effective upon commencement of air service therefrom, but the Company has recently filed an Application with the Regional Airport Board for a determination that Southwest is exempt from such requirement of the Bond Ordinance or, in the alternative, that the provisions of such Ordinance should be waived as to Southwest on the ground that there is an overriding public need for continuance of decentralized, certificated air carrier service emanating from Love Field for short-haul commuter flights. No action upon the Company's application has yet been taken by the Regional Airport Board, but the Company strongly feels that under the law and facts involved it is entitled to either an exemption or a waiver enabling it to maintain air service operations at Dallas' Love Field.

TO OUR SHAREHOLDERS

The year 1971 was a busy and eventful year for Southwest Airlines Co. It was the year during which the dreams of a handful of strong Texas supporters turned into reality. The year really began for Southwest on December 7, 1970, when the U. S. Supreme Court declined to review the unanimous decision of the Texas Supreme Court sustaining the issuance of a Certificate of Public Convenience and Necessity to Southwest by the Texas Aeronautics Commission to operate intrastate flights with large aircraft between the Texas cities of Dallas/Fort Worth, Houston, and San Antonio. Thus the Company was free to proceed with its plan for operation after the expenditure of some $530,000 during a three-year legal battle through four courts. Such costs appear on Southwest's balance sheet as Certification Costs and are being amortized over the five-year period ending June 30, 1976.

Pre-operating period

On January 1, 1971, the company's principal asset consisted of its Certificate of Public Convenience and Necessity against which it had current liabilities of $110,000 and a stockholder equity of $430,000. To begin operations by mid-1971, it was necessary to (1) raise interim capital in an amount sufficient to build an organization and obtain necessary facilities and ground equipment to commence operations; and (2) arrange permanent financing for purchase of required flight equipment and to provide for the operating losses which would be incurred during the company's initial operating period while traffic was being built to a profitable level.

On March 10, 1971, the company sold $1,250,000 of 7% Convertible Promissory Notes due March 10, 1973, to a group of private investors, such notes being convertible into common stock at $8.00 per share. In connection with the sale of these notes, five-year warrants to purchase 125,000 shares of common stock at $6.05 per share (55% of public issue price) also were issued. The funds received from this transaction were partially utilized to bring Southwest into being as an operating company, fully trained and ready to go, together with an extensive initial advertising campaign to inform potential customers of our new service. The total costs incurred during our pre-operating period extending through June 17, 1971, amounted to $1,039,000 as set forth in the Statement of Pre-Operating Costs included in the financial statements.

On June 8, 1971, the company's underwriters purchased 650,000 shares of the company's common stock included in a Registration Statement which became effective that day and a week later purchased an additional 15,000 shares through their overallotment option for all of which the company received net proceeds of $6,570,000 after underwriting discounts, commissions, and other costs.

Scheduled Service Begins

On June 18, 1971, the company began scheduled service with three Boeing 737-200 aircraft seating 112 passengers each. The initial schedule consisted of 12 round trips daily between Dallas Love Field and Houston Intercontinental Airport and six round trips between Dallas and San Antonio. On October 1, 1971, a fourth Boeing 737-200 was added to the fleet with frequency increases to 14 and 7 round trips respectively, offering hourly service on the Houston route and every other hour service on the San Antonio route. In mid-November, half of our Dallas/Fort Worth-Houston service was transferred to the close-in Hobby Airport in Houston, and service was inaugurated between San Antonio and Houston's Hobby Airport. The Love Field-Hobby service has proven to be so convenient for our commuter traffic that additional flights have been moved from Intercontinental to Hobby Airport effective March 1, 1972. Also effective in mid-November was the cancellation of all weekend schedules wtih the exception of a limited Sunday afternoon schedule pattern.

From inception of operations through December 31, the company operated 99% of its scheduled trips with 97% of such trips operating within five minutes of scheduled departure time, a record unparalleled in the industry. We are convinced that our equipment, our facilities, and particularly our employees are equal or superior to those of any of our competitors. As we watch our total traffic and share of market build during each month of operation we gain confidence that the traveling public increasingly agrees with us.

Management's Assignment

The task your management faces in the future is to conduct the company's affairs in such a manner that its operating revenues reach a level which will permit profitable operations prior to the time that our "war-chest" fund obtained for this purpose is expended. We are encouraged that this will be accomplished since: (1) we have passed through the critical period ended December 31, 1971, with a remaining cash balance in excess of $3 million; and (2) each month since August we have reduced the net outflow of cash expended in our scheduled operations, as set forth in table 3 of this report.

If the present trendlines continue, and we see no reason for them not to do so, our scheduled operations should produce positive cash flows within the forseeable future, which funds will be applied toward further principal reduction of our long-term debt to The Boeing Company incurred at the time of delivery by Boeing of our four aircraft and related support equipment.

Our average passenger loads in January, 1972 were some 57% higher than the loads experienced during our first full month of operation, and while future improvement is not expected to be this dramatic, it should reflect a solid growth pattern. Our estimated share of the Dallas/Houston local commuter market has steadily increased from an initial 26% in July to 37% in December, while our principal competitor has gone from 75% prior to our entry in this market to an estimated 46% of the market in December, 1971.

Past, Present and Future

The loss from operations for the period from June 18 through December 31, 1971, of $2,713,000 is substantial and, of course, more than we would have liked it to have been. The intense competition we have faced from competitive carriers has slowed our traffic growth below our original projections. The trendlines are in the right direction, however, and we are particularly encouraged by the traffic growth we have enjoyed since we began providing service to the close-in Hobby Airport in Houston. Your management looks upon the pre-operating costs and the operating loss incurred in 1971 and to be incurred in 1972 as an investment in Southwest's future.

It has been most gratifying to the members of your Board of Directors and management team to receive the wholehearted support and dedication of our 195 employees, the governments of the cities we serve, the major air carriers which unselfishly have made facilities available to Southwest in the crowded terminals from which we operate, our major creditor the Boeing Company, and last, but certainly not least, the ever expanding list of loyal customers we serve.

Cordially yours,

M. Lamar Muse
President and Chief Executive Officer

March 21, 1972

M. Lamar Muse
President and Treasurer

OFFICERS & DIRECTORS

OFFICERS

M. Lamar Muse
President and Treasurer

Rollin W. King
Executive Vice President–Operations

Jess R. Coker
Vice President–Marketing

W. W. Franklin
Vice President–Ground Operations

Donald G. Ogden
Vice President–Flight Operations

John A. Vidal
Vice President–Maintenance & Engineering

Herbert D. Kelleher
Secretary

Carole Ann Skidmore
Assistant Secretary

Fred A. Rigby, Jr.
Comptroller

DIRECTORS

Todd Alexander
New York, New York

A. A. Bradford
Midland, Texas

Herbert D. Kelleher
San Antonio, Texas

Rollin W. King
Dallas, Texas

John D. Murchison
Dallas, Texas

M. Lamar Muse
Dallas, Texas

John Peace
San Antonio, Texas

BALANCE SHEET

December 31, 1971 and 1970

ASSETS

	1971	1970 (Note 1)
Current assets:		
Cash	$ 231,530	$ 183
Certificates of deposit	2,850,000	—
Accounts receivable:		
Trade	300,545	—
Interest	35,013	—
Other	32,569	100
	368,127	100
Less allowance for doubtful accounts	30,283	—
	337,844	100
Inventories of parts and supplies, at cost	171,665	—
Prepaid insurance and other	156,494	31
Total current assets	3,747,533	314
Property and equipment, at cost (Note 2):		
Boeing 737-200 jet aircraft	16,263,250	—
Support flight equipment	2,378,581	—
Ground equipment	313,072	9,249
	18,954,903	9,249
Less accumulated depreciation and overhaul allowance	1,096,177	—
	17,858,726	9,249
Deferred certification costs, less amortization (Note 1)	477,122	530,136
	$22,083,381	$539,699

See accompanying notes.

LIABILITIES AND STOCKHOLDERS' EQUITY

	1971	1970 (Note 1)
Current liabilities:		
Accounts payable	$ 355,539	$ 30,819
Accrued salaries and wages	54,713	79,000
Other accrued liabilities	301,244	—
Long-term debt due within one year (Note 3)	1,500,000	—
Total current liabilities	2,211,496	109,819
Long-term debt due after one year (Note 3):		
7% Convertible Promissory Notes due 1973	1,250,000	—
Support equipment instalment note (1½% over prime rate)	1,305,859	—
Aircraft equipment instalment note (1½% over prime rate)	15,497,786	—
	18,053,645	—
Less amounts due within one year	1,500,000	—
	16,553,645	—
Stockholders' equity (Note 4):		
Common stock, $1.00 par value, 2,000,000 shares authorized, 1,058,758 issued (372,404 at December 31, 1970)	1,058,758	372,404
Capital in excess of par value	6,012,105	57,476
Deficit	(3,752,623)	—
	3,318,240	429,880
	$22,083,381	$539,699

See accompanying notes.

STATEMENT OF PRE-OPERATING COSTS

For the period January 1, 1971 to June 17, 1971

Pre-operating costs:	
Crew training	$ 362,341
Advertising	290,617
Legal and professional fees	183,907
Salaries and wages	161,484
Other	41,326
Total pre-operating costs	$1,039,675

See accompanying notes.

STATEMENT OF OPERATIONS

For the period June 18, 1971 to December 31, 1971

Transportation revenues:		
Passenger		$2,054,381
Other		78,134
		2,132,515
Operating expenses:		
Operations and maintenance (Note 2)	$2,785,890	
Marketing and promotion	541,710	
General and administrative	240,979	
Depreciation and amortization (Note 2)	721,726	4,290,305
Operating loss		2,157,790
Other expense (income):		
Interest (net of interest income of $104,159)	557,738	
Other	(2,580)	555,158
Loss before extraordinary charge		2,712,948
Extraordinary charge — write-off of pre-operating costs (Note 1)		1,039,675
Net loss		$3,752,623
Loss per share of common stock outstanding:		
Loss before extraordinary charge		$2.56
Extraordinary charge		.98
Net loss		$3.54

See accompanying notes.

STATEMENT OF CHANGES IN FINANCIAL POSITION

Year Ended December 31, 1971

Sources of working capital:		
Issuance of long-term debt		$17,255,859
Common stock issued		6,640,983
		23,896,842
Uses of working capital:		
Additions to property and equipment		18,945,654
Principal payments on long-term debt		702,214
Pre-operating costs for the period January 1, 1971 to June 17, 1971 (Note 1)		1,039,675
Applied to operations:		
Loss before extraordinary charge for the period June 18, 1971 to December 31, 1971	$2,712,948	
Less charges not involving working capital in the period:		
Depreciation provision (Note 2)	(668,713)	
Overhaul allowance (Note 2)	(427,464)	
Amortization of deferred certification Costs (Note 1)	(53,014)	1,563,757
		22,251,300
Increase in working capital		$ 1,645,542
Changes in components of working capital:		
Increase in current assets:		
Cash		$ 231,347
Certificates of deposit		2,850,000
Accounts receivable		337,744
Inventories		171,665
Prepaid insurance and other		156,463
		3,747,219
Increase (decrease) in current liabilities:		
Accounts payable		324,720
Accrued salaries and wages		(24,287)
Other accrued liabilities		301,244
Long-term debt due within one year		1,500,000
		2,101,677
Increase in working capital		$ 1,645,542

See accompanying notes.

NOTES

To Financial Statements
Year Ended December 31, 1971

1. Organization and initial operations of the Company

Southwest Airlines Co., incorporated on March 9, 1967, and certificated by the Texas Aeronautics Commission to engage in intrastate air service between the cities of Dallas/Fort Worth, Houston and San Antonio, Texas, commenced scheduled flight operations on June 18, 1971.

In connection with its planning and development, and the obtaining of authorization for its proposed air service, including protracted litigation with respect thereto, the Company incurred costs aggregating $530,136 through December 1970. These certification costs have been deferred in the accompanying financial statements and are being amortized by charges to income over the first five years of scheduled flight operations.

In addition to the certification costs, during the period January 1, 1971 to June 17, 1971, the Company incurred pre-operating costs totaling $1,039,675 in preparation for flight operations. The Company has elected to expense these costs in its initial operating period and, accordingly, such costs are reflected in the accompanying statement of operations as an extraordinary charge.

The amounts shown in the accompanying balance sheet at December 31, 1970 have been restated from amounts previously reported to give effect to certain minor reclassifications and adjustments and to reflect the write off against capital in excess of par value of the excess ($142,421) of the par value of shares issued over cost to a stockholder of certain properties acquired from the stockholder in 1967 by the issue of 150,000 shares of the Company's common stock.

2. Property and equipment

Provisions for depreciation of flight and other equipment have been computed on the straight-line method. The estimated useful lives and salvage values currently used for the principal asset classifications are as follows:

	Estimated life	Salvage value
Boeing 737-200 aircraft and related spare engines and flight equipment	12 years	4%
Ground equipment	10 years	10%
Surface transport vehicles and equipment	5 years	20%
Furniture and fixtures	10 years	10%
Leasehold improvements	Period of leases	—

The Company is providing for major maintenance and overhaul to be performed on its aircraft and engines in future periods by providing a reserve for airworthiness at the rate of $100 for each hour of flight. The accumulated reserve for such future costs aggregated $427,464 at December 31, 1971. Routine and regular maintenance costs are charged to expense as incurred.

3. Long-term debt

On March 10, 1971, the Company issued $1,250,000 in 7% Convertible Promissory Notes bearing a stated maturity date of March 10, 1973. By terms of the agreement related thereto, the Notes may be, at the option of the holders thereof, converted into an aggregate of 156,250 shares of common stock at a conversion price of $8.00 per share. In connection with the sale of the Notes, the Company issued warrants to the noteholders covering an aggregate of 125,000 shares of common stock, such warrants being exercisable through March 10, 1976 at $6.05 per share.

During 1971, the Company entered into a Conditional Purchase Agreement with The Boeing Company which provided for the purchase of four new Boeing 737-200 jet aircraft at an aggregate price of $16,200,000, with principal and interest payable in 72 monthly instalments of $200,000 each (commencing with the delivery of the aircraft) and with the remaining balance due at the end of that time. Three of the aircraft were placed in service in June with the fourth being received in September 1971. Title to the aircraft is to be conveyed upon payment of the full purchase price by the Company, and the obligation bears interest on the unpaid balance at a rate equivalent to 1½% above the prime commercial rate at a specified bank.

In connection with the Conditional Purchase Agreement referred to above, it has been agreed that Boeing will finance 50% of the Company's purchases from or through Boeing of spare engines and parts, support equipment and tooling and test equipment, with the total cost thereof not to exceed $2,800,000. Under the agreement, the Company's obligation bears the same rate of interest as previously described in connection with the aircraft purchase, with payments on the obligation to be in

15 quarterly instalments of $100,000 each (commencing 9 months after delivery of the last aircraft) and a final 16th quarterly instalment covering the balance.

4. Stockholders' equity

On June 8, 1971, 665,000 shares of the Company's unissued common stock were sold to the public. The following summarizes the results of that sale and other transactions affecting the common stock and capital in excess of par value accounts during the year 1971:

	Common stock	Capital in excess of par value
Balance at December 31, 1970 (as restated — see Note 1)	$ 372,404	$ 57,476
Public sale of shares of stock, net of expenses of sale	665,000	5,905,150
Other issuances of shares for cash and in lieu of compensation	21,354	49,479
Balance at December 31, 1971	$1,058,758	$6,012,105

The Company has reserved for issuance, on exercise of warrants and on conversion of the Convertible Notes (see Note 3), 125,000 and 156,250 shares of common stock. In addition, in connection with the issuance of the Convertible Notes, 243,000 shares of the Company's common stock outstanding at December 31, 1971 are subject to a voting trust exercisable by the holders of the Notes upon the occurrence of an event of default as defined in the Note Purchase Agreement pursuant to which the Notes were issued.

Certain officers and directors (or associates thereof) of the Company have waived their rights to participate in dividends and distributions of assets with respect to an aggregate of 235,000 outstanding shares of common stock and 15,000 shares of common stock issuable on the exercise of warrants until the Commissioner of Corporations of the State of California shall by order eliminate the requirement for such waiver.

5. Federal income tax

At December 31, 1971, the Company has a net operating loss of approximately $3,250,000 which may be availed of in future periods as an offset to taxable income. In addition, unused investment tax credits aggregate approximately $400,000.

AUDITOR'S REPORT

ARTHUR YOUNG & COMPANY

4800 ONE SHELL PLAZA
HOUSTON, TEXAS 77002

The Board of Directors and Stockholders
Southwest Airlines Co.

We have examined the accompanying balance sheet of Southwest Airlines Co. at December 31, 1971 and the related statements of pre-operating costs for the period January 1, 1971 through June 17, 1971, operations for the period June 18, 1971 through December 31, 1971, and changes in financial position for the year ended December 31, 1971. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

As explained in Note 1, the Company was in the development and pre-operating stage from March 9, 1967 (date of incorporation) through June 17, 1971, and certain costs incurred during that period have been deferred in the accompanying balance sheet. In addition, the Company has operated at a loss during its initial operating period (June 18, 1971 through December 31, 1971) and anticipates continued operating losses for some months into the future. Accordingly, recovery of the carrying value of its assets is dependent upon the ability of the Company to achieve profitable operations in future periods and the obtaining of such additional financing, if any, as may be required in connection therewith.

In our opinion, subject to the outcome of the matters described in the preceding paragraph, the statements mentioned above present fairly the financial position of Southwest Airlines Co. at December 31, 1971, its pre-operating costs for the period January 1, 1971 through June 17, 1971, the results of its operations for the period June 18, 1971 through December 31, 1971, and the changes in its financial position for the year ended December 31, 1971, in conformity with generally accepted accounting principles applied consistently during each of the respective periods.

Arthur Young & Company

Houston, Texas
February 18, 1972

SELECTED TRENDS OF PROGRESS SOUTHWEST AIRLINES

Monthly Growth Of Southwest Airlines Share Of Dallas / Houston Passenger Market

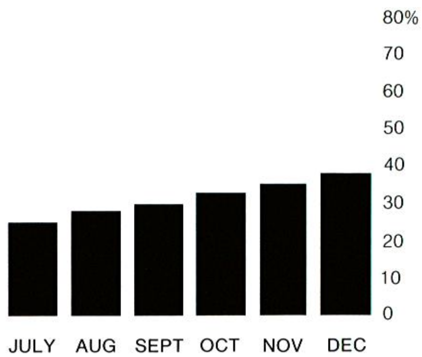

TABLE 1

Southwest Airlines' Impact On Dallas-Houston Commuter Market During 1971

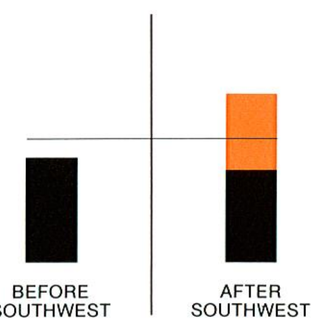

TABLE 2

Decrease In Outflow Of Cash From Operations

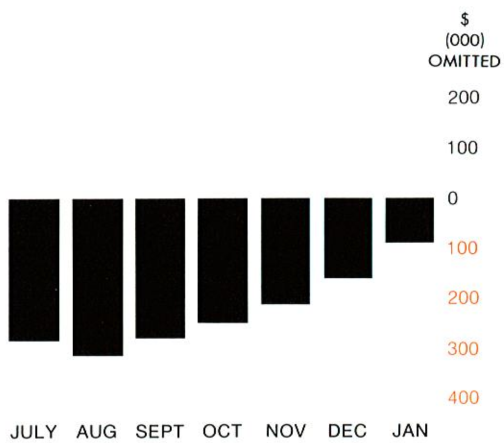

TABLE 3


AIRLINES
RLINES

SOUTHWEST AIRLINES

3300 Love Field Drive ♡ Dallas, Texas 75235