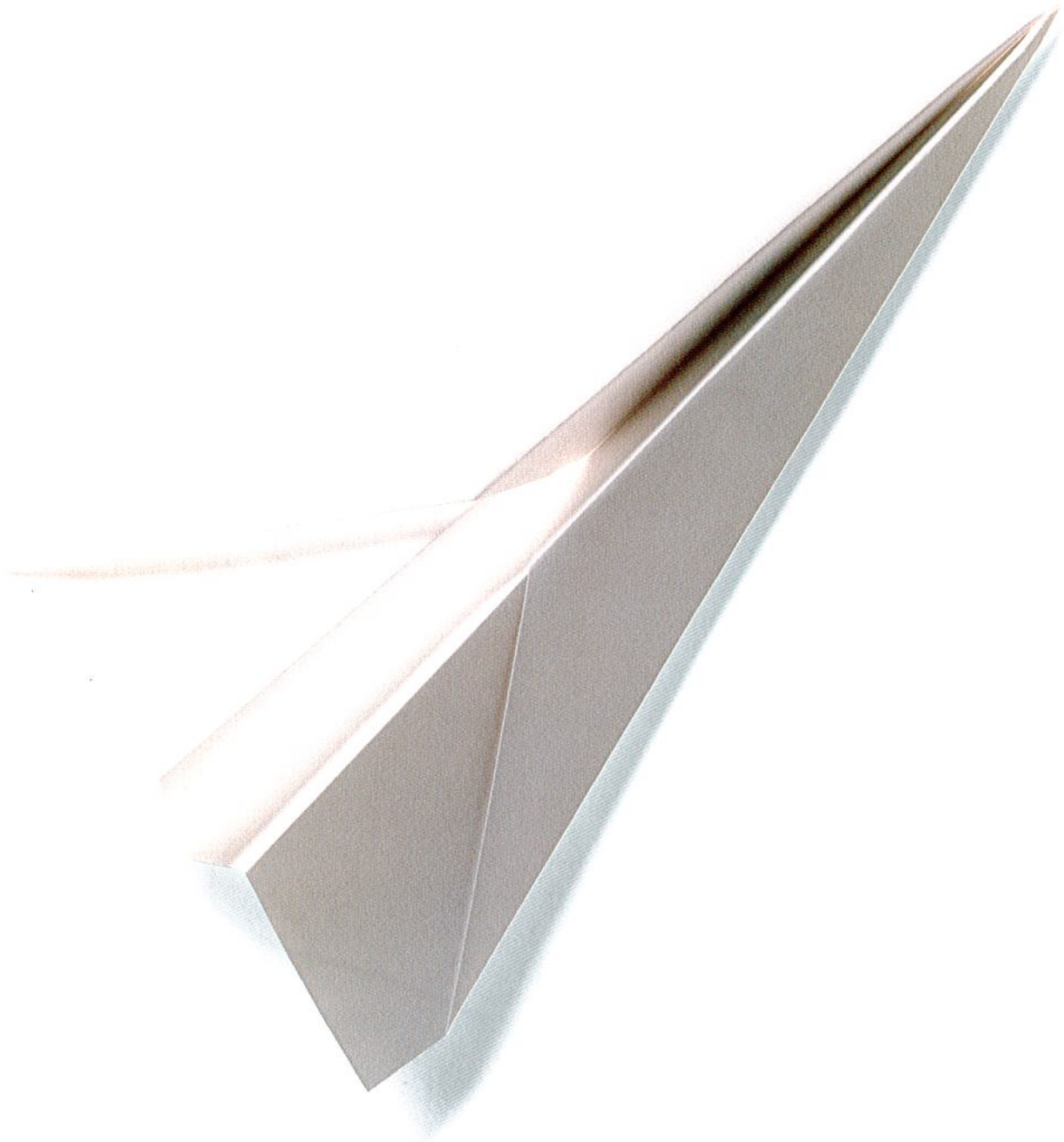


**Southwest Airlines Co.**  
1988 Annual Report



*Back to Basics*

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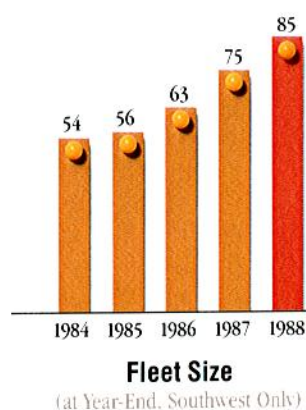
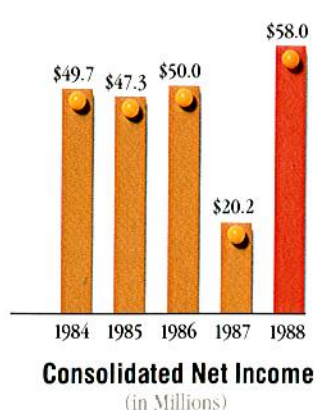
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## CONSOLIDATED HIGHLIGHTS

(dollars in thousands, except per share amounts)

	1988	1987	Percent Change
Operating revenues	\$860,434	\$778,328	10.5
Operating expenses	\$774,454	\$747,881	3.6
Operating income	\$85,980	\$30,447	182.4
Operating margin	10.0%	3.9%	6.1 pts.
Net income	\$57,952	\$20,155	187.5
Net income per common share	\$1.84	\$0.63	192.1
Stockholders' equity	\$567,375	\$514,278	10.3
Return on average stockholders' equity	10.8%	4.0%	6.8 pts.
Long-term debt as a % of total invested capital	39.4%	32.8%	6.6 pts.
Stockholders' equity per common share	\$18.15	\$16.43	10.5
Revenue passengers carried	14,876,582	13,503,242	10.2
Revenue passenger miles (RPM) (000s)	7,676,257	7,789,376	(1.5)
Available seat miles (ASM) (000s)	13,309,044	13,331,055	(.2)
Passenger load factor	57.7%	58.4%	(.7) pts.
Passenger revenue yield per RPM	10.79¢	9.65¢	11.8
Operating revenue yield per ASM	6.47¢	5.84¢	10.8
Operating expenses per ASM	5.82¢	5.61¢	3.7
Number of employees at year-end	6,467	5,765	12.2

Note: Operating income and related operating data include the results of TranStar through June 30, 1987. After that date, TranStar decided to cease its operations and liquidate its assets and liabilities and, accordingly, is excluded from operations. For further discussion, see Note 2 to the Consolidated Financial Statements.



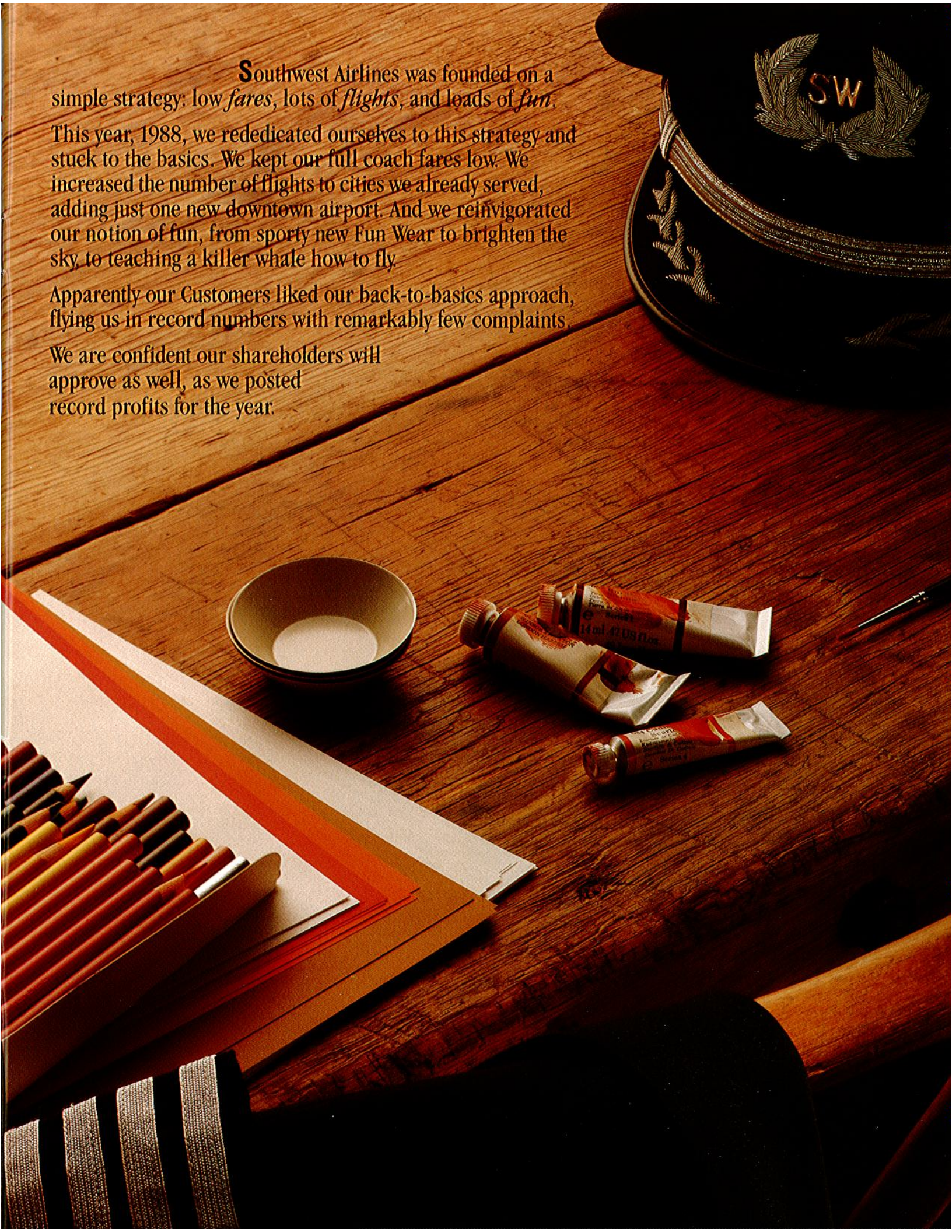


Southwest Airlines was founded on a simple strategy: low *fares*, lots of *flights*, and loads of *fun*.

This year, 1988, we rededicated ourselves to this strategy and stuck to the basics. We kept our full coach fares low. We increased the number of flights to cities we already served, adding just one new downtown airport. And we reinvigorated our notion of fun, from sporty new Fun Wear to brighten the sky, to teaching a killer whale how to fly.

Apparently our Customers liked our back-to-basics approach, flying us in record numbers with remarkably few complaints.

We are confident our shareholders will approve as well, as we posted record profits for the year.





## TO OUR SHAREHOLDERS

In my letter to you in our 1987 Annual Report I concluded by stating: "I believe we can assure our shareholders that our financial results for 1987 do not typify our position in our industry." Our results for 1988 validate that statement.

In the fourth quarter of 1988 Southwest earned \$16,073,000, or \$.51 per share, an 80% increase over the \$8,922,000 (\$.28 per share) earned in fourth quarter 1987. For the year 1988 we earned \$57,952,000, or \$1.84 per share, which not only exceeded our 1987 earnings of \$20,155,000 (\$.63 per share) by 188% but also eclipsed our all-time record annual profit of \$50,035,000 established in 1986.

1988 was, indeed, a gratifying year as compared to 1987. Our principal disappointment, however, was that, after exclusion of nonoperating gains, our 1988 pretax income of \$77,020,000 represented a margin of but 8.95% on operating revenues. In large part, this deficiency in our 1988 "pretax operating margin" was caused by our very slow first quarter in which our pretax income was only \$243,000 and our "pretax operating margin" was substantially less than 1.0%. As of this date, it would appear that our "back to basics" 1989 first quarter will be considerably more rewarding than first quarter 1988.

As I write this letter, the year 1989 seems to hold substantial promise for greater profitability than 1988. Acting in part upon this premise, we increased our regular dividend by 7.7% in the fourth quarter of 1988 and will soon complete the first quarter 1989 repurchase of 1,000,000 shares of our common stock, which tends to have the effect of enhancing our return on equity and of increasing our earnings per share and stock price.

My principal concerns about 1989 results are fourfold:

- 1) The possibility of a recession, which would reduce the demand for our services;
- 2) Continuing escalation in crude oil prices, which is, to some extent in the case of Southwest, counterbalanced by improvements in the energy belt economies and by increases in gasoline prices which render the automobile a less formidable competitor;
- 3) Maintenance of reasonable wage and benefit levels which will enable us to continue to compete effectively against airlines with far lower wage and benefit costs than Southwest;
- 4) The fact that a considerable part of our 1989 available seat mile increase of approximately 10% will be devoted to new city service, entailing the substantial expense and lead time to establish market presence and then market profitability.

1989 could be a "bumper" year. If it so eventuates, the "power and the glory" will belong to the magnificent people of Southwest Airlines who, in their sincerity, striving and caring, are unequalled elsewhere in our industry and elsewhere in our nation.

Most sincerely,



Herbert D. Kelleher  
Chairman, President and  
Chief Executive Officer





Kelleher was chosen by his fellow airline CEOs to chair the Partnership for Improved Air Travel, a broad-based national organization headquartered in Washington, D.C., whose purpose is to develop a greater understanding of the needs of our air travel system and to build private and public sector support, at the local and national levels, so that steps will be taken to meet those needs.



**PARTNERSHIP  
FOR IMPROVED  
AIR TRAVEL**

Southwest Airlines Co. provides single class air transportation characterized by frequent, high quality service at affordable prices. We primarily serve short-haul city pairs, targeting the business commuter as well as leisure travelers. The Company was incorporated in Texas and commenced Customer service on June 18, 1971 with four Boeing 737 aircraft serving three Texas cities — Dallas, Houston and San Antonio. At year-end 1988, Southwest operated 85 Boeing 737 aircraft and provided service to 29 airports in 27 cities in the mid-western, southwestern and western regions of the United States. The Company has one of the best overall Customer service records, the lowest operating cost structure per average stage length and consistently offers our Customers the lowest and simplest fares in the domestic airline industry.



## BACK TO LOW FARE LEADERSHIP

This was the year Southwest recaptured our position as the nation's low fare leader, a position we intend to occupy for the foreseeable future.

The major contributor to our success was the revitalization of our super low, advance purchase Fun Fares. To capitalize on the industry trend toward rising airfares, we marketed our Fun Fares all year long, much to the delight of our Customers.

During the holiday season, we rewarded them again with a special gift — a free companion ticket with the purchase of a special meal at participating Burger King restaurants.

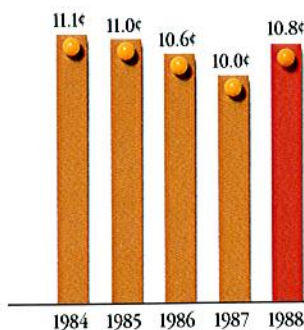
Thanks to competitive trends toward higher fares, our continued commitment to low fares and a consistent, aggressive marketing and promotional effort, our back-to-basics approach has landed us back in the coveted position of low fare leadership in the minds of our Customers.

**FARE STRUCTURE** The airline industry has flooded the marketplace in the '80s with numerous, complex fares. Other airlines cannot match Southwest's low operating costs and, therefore, cannot afford to offer the low unrestricted fares that Southwest provides to our Customers. However, the airline industry is innovative and, in the early '80s, competitors initiated a pricing scheme that offered, on a limited basis and with numerous restrictions, low fares matching Southwest's.

In 1988, Southwest reestablished ourselves as the low fare leader in the domestic airline industry. We accomplished this by avoiding significant system-wide fare increases, maintaining low, unrestricted, unlimited everyday coach fares and by expanding and modifying the discounted Fun Fares first introduced in 1986. In addition, Southwest continued to offer special discounts to senior citizens, children and other special categories of Customers. It is this simple but highly competitive and profitable formula that enables Southwest to best serve the needs of our marketplace and provide a good return to our shareholders.

Our fare structure incorporates three distinct categories of fares: Our unrestricted, unlimited coach fares are offered on a "peak/off-peak" basis. Our advance purchase, nonrefundable Fun Fares represent a further discount from Southwest's low coach fares and are particularly desirable for leisure class Customers who can plan their travel in advance. Our third category of discounted fares is offered to Customers that match certain profiles: senior citizens, youth, children and military personnel. Generally, these fares carry few restrictions.

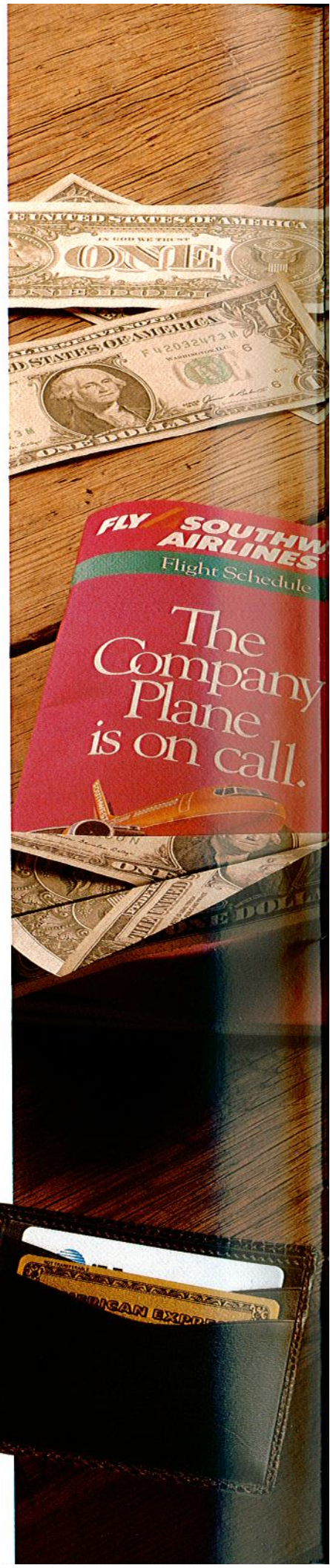
Managing these fares and the seat inventories to be allocated to them is a complex task in an ever-changing environment. Southwest employs revenue maximization techniques based on historical trends and actual bookings by fare category. The net result of the emphasis on revenue management in 1988 was an increase of 5.6% in passenger revenue yield per available seat mile and 7.8% in passenger revenue yield per passenger mile, in comparison to 1987 amounts excluding TranStar.



**Average Revenue Per Passenger Mile**  
(Southwest Only)



*For tens of thousands of frequent flyers, The Company Club™ continues to be the shortest route to free trips.*







Southwest Airlines has long been America's low fare leader. But in recent years, competitive actions have eroded public perception of this fact. Our own aggressive marketing and promotional efforts this year, coupled with the continued success of The Company Club™, have helped us recapture public awareness of our low fare leadership.



BEACH BOYS MUSIC: "Well, you've waited so long for a fare to get so nice and low now..."



"... and you'll have fun, fun, fun..."



"... flyin' Southwest on a Fun Fare today!"



## BACK TO FREQUENT FLIGHTS

This was the year Southwest resisted the temptation to open a lot of new cities. We successfully opened one new downtown airport, Detroit City Airport, in the spirit of Dallas Love Field, Houston Hobby and Chicago Midway. But getting back to basics meant reemphasizing Southwest's position as the nation's premier short-flight, point-to-point airline with lots of daily flights to the cities we serve. We communicated our *convenience* strength more consistently and more effectively in a series of "blocking and tackling" television commercials clearly and simply defining two of our strategic advantages — lots of flights and super low fares. Apparently our Customers got the message. We posted one of our strongest ever third and fourth quarter performances and earned record income for the year.

**SCHEDULING STRATEGY** Southwest employs a point-to-point method of scheduling our aircraft, a strategy designed to best serve the local short-flight business traveler. This scheduling approach is more convenient than the hub-and-spoke strategy employed by other large U.S. airlines and enables the Company to offer a large number of convenient daily departures between nonstop city pairs, keeping total ground and flight time to a minimum. Avoiding congested hubs also improves our ability to maintain our outstanding on-time performance record.

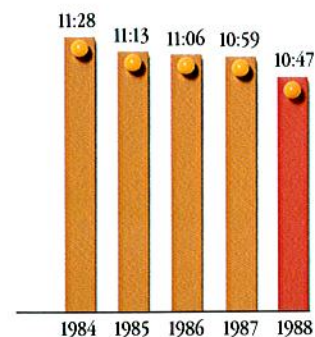
Southwest operated 881 daily weekday departures during the 1988 peak travel season, up 14% from last year's schedule of 772 departures a day. The increase of 109 departures a day was almost totally dedicated to increasing frequencies in existing markets. In the largest three markets, Houston Hobby, Dallas Love, and Phoenix Sky Harbor, scheduled daily departures were increased as follows:

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	1988	1987	Increase	Percentage Increase
Houston Hobby	121	103	18	17
Dallas Love	119	114	5	4
Phoenix Sky Harbor	104	77	27	35
Total	344	294	50	17

Thus, 39% of Southwest's daily departures originated from these three cities and, of the increase of 109 daily flights, 46% were deployed to these markets. San Antonio, Chicago, Albuquerque and Austin are the next largest cities in terms of daily departures. Southwest's presence in our 29 airport locations is strong, as we are either the largest or second largest carrier, in terms of passenger boardings, at 18 of these airport locations according to December 1988 figures. Southwest continues to dominate the Texas landscape as we rank first at 10 of the 11 airports we serve.

Southwest remained committed to short-haul markets in our 1988 scheduling with an average stage length of 378 miles, an average trip time of just over an hour and daily aircraft utilization of almost 11 hours. Southwest's Customers also flew principally short-haul, with an average passenger trip length in 1988 of 516 miles.



**Aircraft Utilization**

(Hours and Minutes per Day, Southwest Only)



*For the eighth year in a row, Southwest Airlines has received the fewest complaints per 100,000 Customers carried of the 11 largest airlines in America.*







Southwest has always been a short-flight, point-to-point airline with lots of flights to cities we serve. This year we have successfully recommitted our efforts to add more flights before adding more cities.

6:35 a.m.  
8:00 a.m.  
9:25 a.m.  
10:30 a.m.

ANNOUNCER: "If these 16 reasons [lots of flights] don't convince you to fly Southwest to Albuquerque..."

\$29

"maybe *this* one [our low fare] will."



"Southwest Airlines. It's like having your own company plane."



## BACK TO LOADS OF FUN

This was the year Southwest reinvigorated our idea of fun.

As our chairman once mused, "We take our competition seriously, but we don't take ourselves too seriously."

A perfect example is our colorful, comfortable, seasonal Fun Wear — casual uniforms that reflect our genuine Southwest hospitality, both on the ground and in the air.

When another airline in Phoenix suggested Southwest flyers might be a bit embarrassed to fly Southwest, Chairman Kelleher responded in characteristic fashion — with a paper bag over his head!

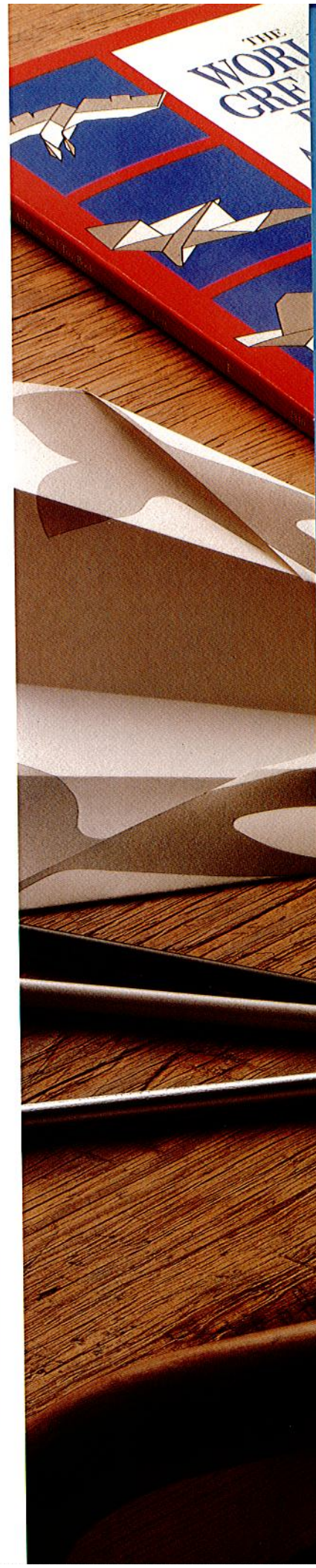
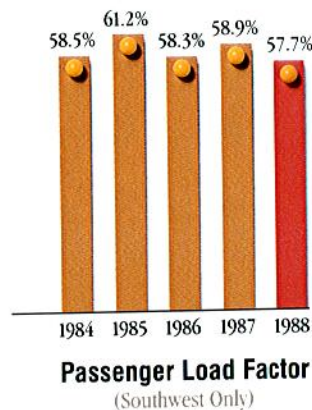
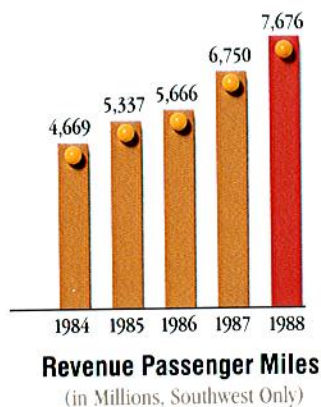
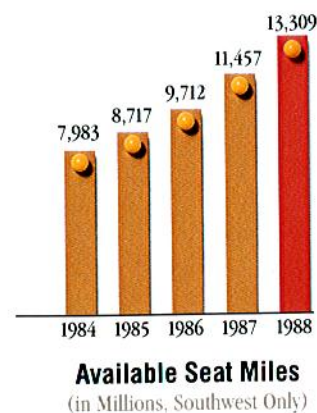
And no airline in the world had as much fun as Southwest this year, when we unveiled the world's first and only flying killer whale, Shamu® One.

**CUSTOMER SERVICE** Southwest has consistently been among the industry's leaders in all facets of Customer service. In 1988, we received the fewest complaints filed with the Department of Transportation (per Customer carried) of the 11 largest carriers in the U.S. We achieved high levels of on-time aircraft arrival performance as compared to our competitors. And we compiled a superb baggage handling record. All this was accomplished through the tireless efforts of Southwest's employees, who continually stress caring, personal Customer service with our own special brand of fun.

Southwest's Customers also benefit from our operating strategy, which keeps total trip time, both on the ground and in the air, to a minimum. We serve close-in downtown airports, schedule on a point-to-point basis and provide quick ticketing, boarding and seating procedures, which combine to expedite all aspects of the trip. This strategy also helps maintain Southwest's low cost structure through higher utilization of aircraft and enhanced employee productivity.

Complementing Southwest's short-haul focus is our efficient, innovative in-flight snack and beverage service. Due to the short duration of most trips, generally one hour or less, no meal service is provided. Yet, Southwest's in-flight service is generally superior to our competitors in short-haul markets, in terms of speed, efficiency and hospitality.

Southwest also offers our frequent Customers free travel awards through membership in The Company Club. Free travel awards, good for one free roundtrip, are earned on a trip frequency basis, initially after 10 roundtrips and, thereafter, after eight roundtrips. Travel certificates permit roundtrip travel anywhere on the Southwest system, are transferable and are valid for travel within one year from the date of the award.





**Shamu One. In celebration  
of the historic partnership  
between Southwest Airlines  
and the Sea Worlds of Texas  
and California, Inaugural Flight  
May 23, 1988. A star is airborne.**







NORTHWEST

N334SW







Sea World  
of





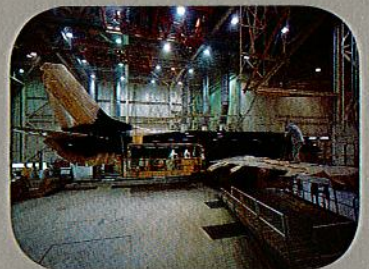
From a gleaming metal skin...



... to a shocking yellow primer...



... to a mysterious white undercoat...



... to a tell-tale black overcoat...



... to a whale that will soon learn to fly.





Southwest Airlines was founded on fun. From our early days of hot pants and "the someone else up there who loves you," we have always done things a little differently. This year we went overboard, introducing one whale of a plane — Shamu One.

THE UNKNOWN FLYER: "If you're embarrassed to fly the airline with the



most convenient schedules and fewest Customer complaints, Southwest will give you this bag..."



"... If, on the other hand, Southwest is your kind of airline, we'll *still* give you this bag..."



"... for all the money you'll save flying with us."



## BACK TO RECORD PROFITS

This was the year Southwest posted all-time record net income.

Eighteen years ago, we founded this airline on a simple strategy: low fares, lots of flights, and loads of fun.

Today, those fundamentals have stood the test of time. And today, we stand proud. As former University of Texas football coach Darrell Royal is fond of saying, "We danced with them that brung us."

*Low fares. Lots of flights. And loads of fun.*

We're not likely to stray far from the basics. But if we do, we know who will get us back on track again: Our Customers.

**OPERATING RESULTS** The year ended December 31, 1988 resulted in record annual operating revenues of \$860.4 million and record net income of \$58.0 million or \$1.84 per share. This significantly surpassed the previous records achieved in 1986 and represented a meaningful recovery from 1987 when net income slipped to \$20.2 million. The poor 1987 performance was principally attributable to losses at TranStar, new reservations system development and the shortage of reservations capacity at Southwest. These problems were resolved during the third quarter of 1987. During 1988, the core strategies of low fares, high frequencies and fun Customer service were executed with innovative tactics resulting in operating revenue per available seat mile up 6.1%, excluding TranStar's operations for 1987. Operating expenses were kept well under control, increasing only 1.4% on a per-ASM basis.

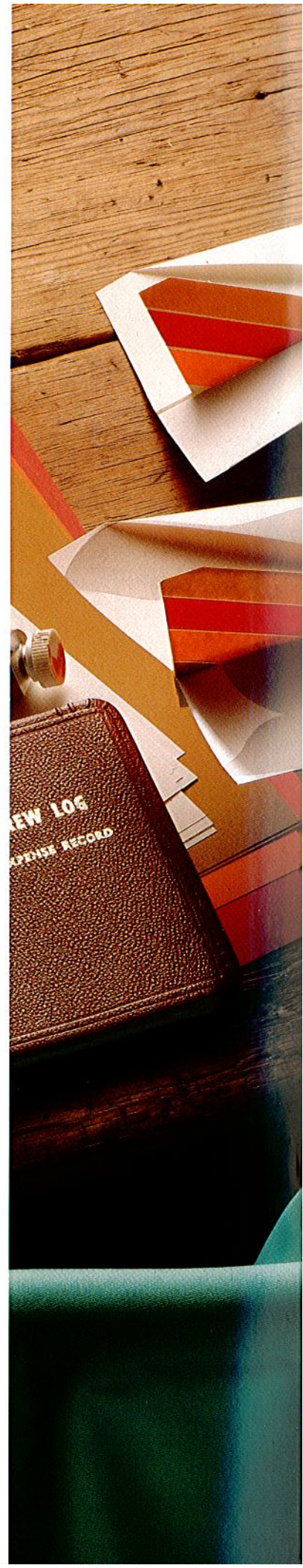
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**OUTLOOK** Despite the excellent 1988 performance and our hopes for an even better 1989, many issues confront the airline industry that could serve to adversely affect financial performance. On the cost side of the profit equation, fuel costs continue to be one of the most volatile and unpredictable. Most notably, crude oil prices are now hovering around \$18 a barrel and, largely depending upon what course the OPEC countries take, could easily go up further. Southwest's average cost per gallon of jet fuel has risen accordingly, from a fourth quarter 1988 average of 47.83¢ per gallon to a January 1989 average of almost 56¢, a 17% increase. However, to the extent that increases in fuel prices result in a resurgence of the energy belt economies or discourage travelers from using their automobiles, Southwest's traffic could be enhanced and potentially offset the increase in fuel costs.

Also on the cost side, labor costs remain the single largest item for Southwest. Fortunately, Southwest enjoys outstanding labor relations, a tribute to both labor and management. However, several labor contracts are up for renegotiation in 1989 including contracts for the pilots, passenger service and fleet service employees. Although the Company cannot predict the ultimate outcome of these negotiations, our goal is to position Southwest and our employees for continued prosperity and job security. We expect to reach agreements that will permit us to achieve both.

On a broader scale, the industry is suffering from an acute shortage of gates, runways, airports and air traffic control capacity. The aviation system has not expanded significantly since the early '70s with the opening of Dallas/Fort Worth Airport. Southwest is an active industry participant in the Partnership for Improved Air Travel, a coalition of airlines, manufacturers, labor unions, general aviation and consumers, which is actively working with Congress on solutions to these major issues. In fact, Southwest's chairman, Herbert D. Kelleher, serves as chairman of the Partnership.

Finally, although the short-term economic outlook for the U.S. is bright, the Company believes we have the financial strength, cost structure, management team and operating strategy to weather a downturn in the economy and to deal appropriately with other business issues that may arise as we serve Customers into the 1990s and beyond.







Southwest proves its point as a short-flight, point-to-point airline with low fares, lots of flights and loads of fun.



## BACK TO OUT-AND-BACK AGAIN

This was the year Southwest added one more downtown airport, Detroit City Airport, and lots more flights to the cities we serve.

At year-end, Southwest was serving 29 airports in 27 cities with over 850 daily flights.

Next year, we expect to add additional flights and one or two additional cities.

Our fleet of Boeing 737-200s and 737-300s, the youngest fleet in the country, will be augmented with the new generation 737-500 beginning in early 1990.

Our steady expansion has earned us a position among the 11 largest airlines in America, and clearly one of the most consistently profitable.

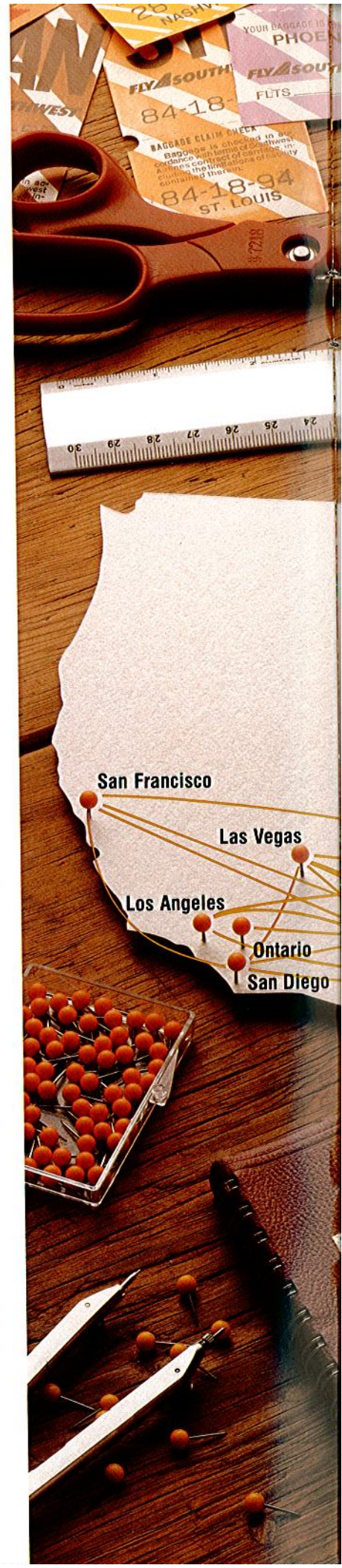
**ROUTE EXPANSION** Southwest's short-haul strategy and point-to-point flight scheduling is targeted primarily at the business commuter. As a result, the Company attempts to identify business communities that would benefit by high frequency, low cost air transportation and ones that are underserved, uncongested and can be stimulated by lower fares. Since Southwest is not a hub-and-spoke operation, we are not dependent upon the expansion capability at a hub, allowing greater freedom for expansion. We also avoid the congestion being experienced at many major airport hubs. Further, Southwest targets new regions so that we are not totally dependent upon the economic fortunes of any single geographic region.

Southwest expanded our ground facilities in Phoenix in 1988 and will further expand facilities in 1989. In 1990, we plan to move into a new terminal, with an increase in gate availability from 12 to 16. The Company also completed a major expansion into Concourse C at Houston's Hobby Airport in 1988, adding five more gates to complement the 10 gates currently in use in Concourse A. Southwest currently operates 12 gates at our Dallas Love Field facility.

**FLEET PLANNING** Southwest's aircraft fleet consists entirely of Boeing 737 aircraft, an aircraft that is attractive and comfortable for our Customers and can be operated cost effectively in Southwest's short-haul markets. This commitment to a single aircraft type allows for efficient and cost effective maintenance and flight operations. The Company added 13 737-300s to our fleet in 1988 and returned three older leased 737-200s to the lessor. At December 31, 1988, Southwest had the youngest aircraft fleet in the nation with an average age of only 5.3 years. Our oldest aircraft is 14 years old and 72 of our 85 aircraft are less than 10 years old. Southwest has firm delivery commitments from Boeing, plus options to acquire additional aircraft to adequately meet our expansion needs. We had aircraft on hand at December 31, 1988, plus future options or firm deliveries, as follows:

	SEATS	1988	1989	1990	1991	1992	1993	1994
737-200	122	46	—	—	—	—	—	—
737-300	137	39	9	—	3	3	3	3
737-500	122	—	—	10	10	10	10	10
Total		85	9	10	13	13	13	13

Of the 737-200 aircraft in the 1988 fleet, 40 are owned, three are subject to long-term capital leases and three are subject to short-term operating leases. The 737-300s in 1988 include 21 owned, seven subject to long-term capital leases and 11 subject to long-term operating leases.









## IN MEMORIAM

Shea Runnels,  
1980-1988

*Goodbye, little friend.  
Tiny crusader against the odds.  
You, who have taught us so much—  
About living.  
About loving.  
About the temporary nuisance of pain  
And the timeless strength of hope.  
Even as we lift you on our heartwings  
To the waiting wings of angels,  
Your smile lives on—  
In those of us you touched  
Oh so fleetingly:  
And forever.*



## DIRECTORS

SAMUEL E. BARSHOP  
Chairman of the Board and President,  
La Quinta Motor Inns, Inc.,  
San Antonio, Texas; Audit and  
Compensation Committees

GENE H. BISHOP  
Chairman of the Board and Chief Executive  
Officer, MCorp, Dallas, Texas (bank holding  
company); Audit, Compensation, and  
Executive Committees

TRAVIS C. JOHNSON  
Partner, Johnson & Bowen,  
Attorneys at Law, El Paso, Texas;  
Audit Committee

HERBERT D. KELLEHER  
Chairman of the Board and President  
of Southwest Airlines Co., Dallas,  
Texas; Executive Committee

ROLLIN W. KING  
Consultant, Executive Development, Dallas,  
Texas; Audit and Executive Committees

WALTER M. MISCHER, SR.  
Chairman of the Board and Chief Executive  
Officer of The Mischer Corporation,  
Houston, Texas (real estate development);  
Audit and Compensation Committees

## OFFICERS

HERBERT D. KELLEHER  
Chairman of the Board, President  
& Chief Executive Officer

ROBERT W. LAWLESS  
Executive Vice President, Chief Operations  
Officer

GARY A. BARRON  
Executive Vice President —  
Corporate Services

COLLEEN C. BARRETT  
Vice President — Administration & Secretary

JOHN G. DENISON  
Vice President — Finance, Chief Financial  
Officer

DANIEL W. HAY  
Vice President — Systems

J. L. HERRING  
Vice President — Energy & Provisioning

CAMILLE T. KEITH  
Vice President — Special Marketing

MARCY E. LAWLESS  
Vice President — Personnel

WILLIAM Q. MILLER  
Vice President — Inflight Service

JAMES F. PARKER  
Vice President — General Counsel

PAUL J. QUINN  
Vice President — Schedule Planning

RON RICKS  
Vice President — Governmental Affairs

PAUL E. STERBENZ  
Vice President — Flight Operations

DONALD G. VALENTINE  
Vice President — Marketing

JOHN A. VIDAL  
Vice President — Maintenance

JAMES C. WIMBERLY  
Vice President — Ground Operations

GARY C. KELLY  
Controller

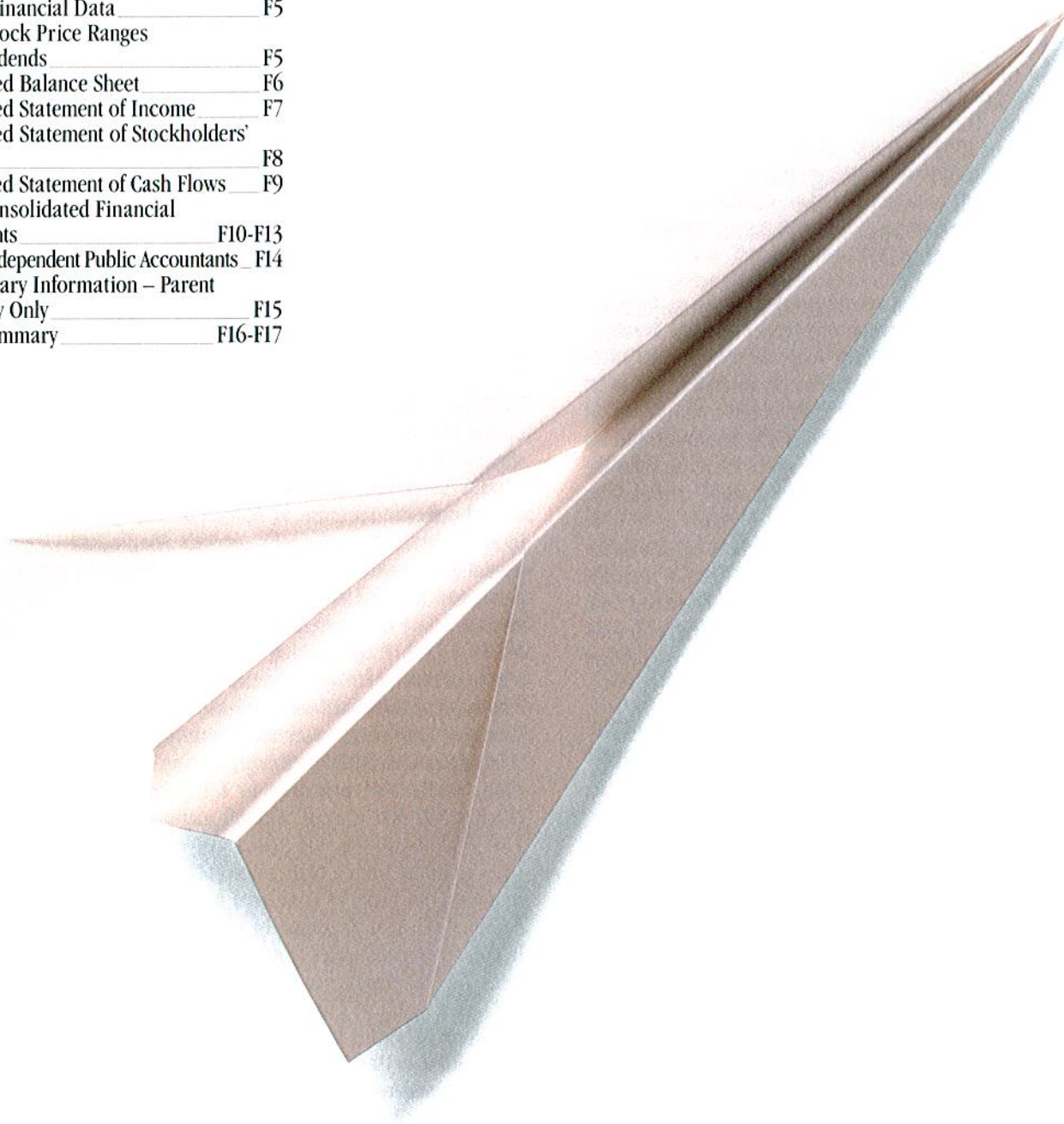
JOHN D. OWEN  
Treasurer



**Southwest Airlines Co.**  
**1988 Annual Report**  
**Financial Review**

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F1

*Back to Basics*



## MANAGEMENT'S DISCUSSION AND ANALYSIS

### RESULTS OF OPERATIONS

**1988 COMPARED WITH 1987** The Company's consolidated net income was \$58.0 million in 1988 compared with \$20.2 million in 1987, an increase of 187.5%. This increase was primarily attributable to an increase in operating income of \$55.5 million. Operating revenues per ASM increased 10.8% versus an increase of only 3.7% in operating expenses per ASM.

**Operating Revenues** Consolidated passenger revenues, which accounted for more than 96% of total consolidated operating revenues, increased by 10.2% in 1988 to an all-time high of \$828.3 million. This resulted from an increase in passenger revenue yield per RPM of 11.8% offset by a slight decrease in consolidated RPMs of 1.5%. Although 1988 RPMs at Southwest increased 926 million over 1987, the effect of discontinuing TranStar in 1987 was a decrease of 1,039 million RPMs in 1988 when compared to 1987 levels.

Southwest's 1988 operating revenues were \$860.4 million, an increase over its 1987 operating revenues, excluding TranStar, of \$161.8 million, or 23.2%. The increase was derived principally from a 22.6% increase in passenger revenues. Southwest added 10 aircraft or 1,852 million ASMs in 1988, an increase of 16.2% compared to Southwest's 1987 levels. Southwest's RPMs increased 13.7% in 1988, a slower rate of increase than the capacity growth of 16.2% resulting in a slight decrease in Southwest's system-wide load factor of 1.2 points to 57.7%. However, the RPM yield increased 7.8%, which, coupled with the 13.7% traffic increase, accounts for the overall 22.6% increase in passenger revenues. The increase in RPM yield resulted from a higher percentage of higher-yielding short-haul traffic in 1988 as compared to 1987 and was achieved without significant system-wide fare increases.

**Operating Expenses** Consolidated operating expenses increased 3.6% in 1988 primarily as a result of a 3.7% increase in operating expenses per ASM.

Operating expenses for Southwest, excluding TranStar in 1987, increased 17.8%, commensurate with its 16.2% increase in ASMs, from \$657.5 million in 1987 to \$774.5 million in 1988. This represents an increase per ASM of only 1.4% over 1987 levels, as follows:

#### Southwest Operating Expenses per ASM

	1988	1987	Increase (Decrease)	Percent Change
Salaries, wages and benefits	1.84¢	1.79¢	.05¢	2.8
Profit sharing	.07	.01	.06	600.0
Fuel and oil	.98	1.06	(.08)	(7.5)
Maintenance materials and repairs	.41	.46	(.05)	(10.9)
Agency commissions	.40	.35	.05	14.3
Aircraft rentals	.17	.13	.04	30.8
Landing fees and other rentals	.30	.29	.01	3.4
Depreciation	.50	.52	(.02)	(3.8)
Other	1.15	1.13	.02	1.8
<b>Total</b>	<b>5.82¢</b>	<b>5.74¢</b>	<b>.08¢</b>	<b>1.4</b>

Southwest's salaries, wages and benefits expenses were largely unchanged from 1987 to 1988 on a per-ASM basis, increasing slightly by 2.8% primarily due to increased benefits costs. Average headcount increased 16.1% in 1988, commensurate with the 16.2% increase in ASMs but less than the 20.8% increase in 1988 passengers carried. Southwest's employee productivity improved in 1988 to an industry-leading 2,414 passengers handled per employee, up from 2,319 in 1987. The average salary cost per employee increased less than 1% from 1987 to 1988. Profit sharing expenses per ASM increased in 1988 as a result of increased profitability as compared to 1987. Fuel expenses declined on a per-ASM basis in 1988 due primarily to a decrease in the annual average cost per gallon of 3.5¢ or 6.4%. In addition, less gallons per ASM were burned in 1988, attributable primarily to a higher mix of more fuel efficient 737-300 aircraft. Aircraft maintenance expenses per ASM declined 10.9% due principally to less engine overhaul costs resulting from a higher percentage of newer engines not requiring overhauls as compared to prior years. Agency commissions per ASM increased 14.3% in 1988 due to an increase in commissionable sales from travel agents in relation to total sales. Aircraft rentals per ASM increased 30.8% in 1988 versus 1987 as a result of financing seven aircraft during 1987 with long-term operating leases. Depreciation expense was reduced \$3.3 million in 1988, or 3.8% per ASM, as a result of a change in the estimated useful lives and residual values of aircraft as further described in Note 12 to the Consolidated Financial Statements.

Other Consolidated other expenses (income) included interest expense, interest income and nonoperating gains and losses. Interest expense decreased in 1988 due to the reduction in TranStar debt of \$75.8 million in connection with the 1987



TranStar shut-down (see Note 2 to the Consolidated Financial Statements). This decrease was partially offset by additional interest expense resulting from Southwest's capital lease financing of five aircraft in 1988. Interest income increased approximately \$3.9 million in 1988 due to higher investment balances available from proceeds of \$158.8 million generated from sale and leaseback aircraft financings. See Consolidated Statement of Cash Flows for further information. Both 1988 and 1987 included nonoperating gains of \$8.3 million and \$14.3 million, respectively, as more fully described in Notes 2 and 9 to the Consolidated Financial Statements.

**Income Taxes** The Provision for income taxes increased in 1988 as a percentage of income before income taxes to 32.1% from 30.7% in 1987, despite a decrease in the federal statutory rate from 40% to 34%. The increase is primarily attributable to a reduction in available investment tax credits as a result of certain transitional rules contained in the Tax Reform Act of 1986. The investment tax credits utilized for financial reporting purposes, after providing deferred taxes for the corresponding reductions in the tax bases of the related assets, have declined from \$8.2 million in 1987 to \$3.4 million in 1988. See Note 10 to the Consolidated Financial Statements for further information.

In December 1987, the Financial Accounting Standards Board (FASB) issued Statement No. 96, "Accounting For Income Taxes," which significantly modified what is currently generally accepted accounting for income taxes. The effect of the Company's anticipated change to this Statement has not been accurately estimated at this date but is expected to be material primarily as a result of reducing net deferred tax credits for reductions in income tax rates promulgated by the Tax Reform Act of 1986 (46% to 40% to 34%). The Statement is required by the FASB to be implemented no later than fiscal year 1990 although earlier adoption is permitted. The Company will adopt the Statement in 1990.

**1987 COMPARED WITH 1986** The Company's consolidated net income was \$20.2 million in 1987 compared with \$50.0 million in 1986, a decrease of 59.7%. This reduction in net income was primarily attributable to a 4.4% decrease in consolidated operating revenue per ASM from 6.11¢ in 1986 to 5.84¢ in 1987 as a result of intense fare competition in the first half of 1987. The Company's discontinued airline operation, TranStar, accounted for losses, after the effect of income taxes, of \$6.1 million during 1987.

**Operating Revenues** Consolidated passenger revenues, which accounted for more than 96% of total consolidated operating revenues, increased by only 1% in 1987 to \$751.6 million due to the discontinuance of TranStar in July 1987 and the 4.4% decline in operating revenue per ASM mentioned above.

Southwest operating revenues, excluding TranStar, accounted for \$698.7 million or 90% of total operating revenues in 1987 versus \$619.7 million in 1986, an increase of 12.7%. Southwest added 12 aircraft or 1,744 million ASMs in 1987, an increase of approximately 18.0% compared to 1986 levels. In addition, the system load factor increased .6 points in 1987 resulting in an additional 70 million RPMs. However, as a result of pricing actions taken to meet competitive fare pressures, operating revenue per ASM decreased 4.4% during 1987 to 6.10¢ compared to 6.38¢ in 1986, which partially offset the effect of the 18.0% increase in ASMs and the .6 point increase in the system load factor.

TranStar's six months of operations accounted for \$80.5 million of total consolidated operating revenues in 1987 as compared to a full year of operations in 1986, which generated revenues of \$149.9 million. TranStar had 1,039 million RPMs with a 55.5% load factor for 1987 as compared to 1,722 million RPMs and a load factor of 60.2% in 1986.

**Operating Expenses** Consolidated operating expenses increased 10.0% in 1987 primarily as a result of increases in ASMs of 6.0% and operating expenses per ASM of 3.7%. The Company's two largest cost categories, "Salaries, wages and benefits" and "Fuel and oil" increased over 1986 levels by 7.4% and 8.3%, respectively, consistent with the 6.0% increase in consolidated ASMs. The cost per ASM for fuel and oil increased modestly in 1987 to 1.05¢ per ASM compared to 1.03¢ in 1986, only a 2.2% increase despite a 5.6% increase in the average price of jet fuel in 1987 compared to 1986. The largest percentage increase in a single cost category occurred in "Aircraft rentals." Southwest financed seven aircraft in 1987 and four in 1986 pursuant to long-term operating leases. TranStar had 10 aircraft subject to long-term operating leases, two of which were added in 1987, that were acquired by a third party in late 1987 as described in Note 2 to the Consolidated Financial Statements. This increase is offset, however, by decreases in depreciation and interest expense and an increase in interest income.

Southwest, excluding TranStar, accounted for \$657.5 million of total consolidated operating expenses, or 5.74¢ per ASM in 1987 as compared to 5.54¢ in 1986. In 1987, operating expenses increased 22% over 1986 operating expenses, primarily as a result of the 18% increase in Southwest's ASMs.



Other Consolidated other expenses (income) decreased substantially in 1987 from \$23.5 million in 1986 to \$1.4 million primarily as a result of large gains realized on the sales of TranStar assets, net of reserves for operating losses during the shut-down period. Interest expense declined in 1987 primarily due to the assumption by a third party of all of TranStar's long-term debt during the third quarter of 1987. Interest income was up dramatically in 1987 as compared to prior periods. Cash balances available for investment were up in 1987 due to \$77.8 million in cash generated from the sale of TranStar assets and \$178.0 million generated from the sale and leaseback of seven aircraft. Both years included nonoperating gains of approximately \$4 million as described in Note 9 to the Consolidated Financial Statements.

**Income Taxes** The Provision for income taxes increased in 1987 as a percentage of income before income taxes to 30.7% from 23.5% in 1986, despite a decrease in the federal statutory rate from 46% to 40%. The increase is primarily due to basis differences in the TranStar assets sold for financial versus income tax reporting purposes resulting in much larger gains for tax reporting purposes, as more fully described in Note 10 to the Consolidated Financial Statements. Investment tax credits, which were available in 1987 as a result of certain transitional rules contained in the Tax Reform Act of 1986, were \$8.2 million in 1987 versus \$11.1 million in 1986, after providing deferred taxes for the corresponding reduction in the tax bases of the related assets.

#### LIQUIDITY AND CAPITAL RESOURCES

The Company had \$112.1 million in working capital at December 31, 1988 as compared to \$88.7 million at December 31, 1987 and \$45.2 million at the end of 1986. Cash provided from operations was \$177.6 million in 1988, up from \$75.1 million in 1987 and \$139.7 million in 1986. Additional funds of \$158.8 million were generated in 1988 through the sale and leaseback of eight aircraft: five were new 737-300 aircraft subject to long-term capital leases with three older 737-200 aircraft subject to short-term operating leases. As a result of the sale and leaseback transactions, obligations under capital leases increased by \$124.1 million. Additional proceeds of \$9.5 million were provided from the early payment of a note receivable. These proceeds were primarily utilized to finance aircraft-related capital expenditures and provide working capital.

In 1987, additional funds of \$178.0 million were provided through the sale and leaseback of seven 737-300 aircraft with another \$163.1 million from the sale of TranStar assets, which included the assignment to a third party of all TranStar long-term debt. These proceeds were utilized to finance aircraft-related capital expenditures and provide working capital. TranStar's aircraft operating leases were also assumed by a third party as more fully described in Note 2 to the Consolidated Financial Statements. As a result of the sale and leaseback transactions, commitments for operating leases increased in 1987 by \$336.3 million.

In 1986, additional funds were provided through the sale of \$100 million of public debt. The proceeds were primarily used to retire certain debt and finance aircraft acquisitions. The Company completed approximately \$100 million of financings in the fourth quarter of 1986 via the sale and leaseback of four aircraft, the proceeds of which were used to retire debt and provide working capital.

Capital expenditures were \$264.5 million in 1988, \$235.0 million in 1987 and \$195.0 million in 1986. The majority of these expenditures were for aircraft delivery or progress payments.

Capital commitments for the Company consisted primarily of scheduled aircraft acquisitions. At year-end, Southwest had 15 737-300s and 15 737-500s on firm order with options to purchase another six 737-300s and up to 35 737-500s. Aggregate funding required for these commitments was \$489.1 million at year-end. See Note 3 to the Consolidated Financial Statements for further information.

The Company has various options available to meet its capital and operating commitments, including cash on hand at December 31, 1988 of \$210.0 million, internally generated funds and a revolving credit line with a group of banks of up to \$170 million (none of which had been drawn at December 31, 1988). In addition, the Company will consider various borrowing or leasing options to maximize earnings and cash flow.



# QUARTERLY FINANCIAL DATA (UNAUDITED)

(in thousands except per share amounts)

1988	Three months ended			
	March 31	June 30	Sept. 30	Dec. 31
Operating revenues	\$178,572	\$216,925	\$239,117	\$225,820
Operating income	1,528	23,512	39,496	21,444
Income before income taxes	243	22,247	39,097	23,773
Net income	168	15,125	26,586	16,073
Net income per common share	.01	.48	.85	.51

1987	Three months ended			
	March 31	June 30	Sept. 30	Dec. 31
Operating revenues	\$178,383	\$205,302	\$200,743	\$193,900
Operating income (loss)	(7,021)	2,796	24,247	10,425
Income (loss) before income taxes	(13,089)	846	30,506	10,810
Net income (loss)	(9,834)	635	20,432	8,922
Net income (loss) per common share	(.30)	.02	.63	.28

## COMMON STOCK PRICE RANGES AND DIVIDENDS

Southwest's common stock is listed on the New York Stock Exchange and is traded under the symbol LUV. The high and low sales prices of the common stock on the Composite Tape and the quarterly dividends per share paid on the common stock were:

Period	Dividend	High	Low
1988			
1st Quarter	\$.0325	\$18.13	\$13.13
2nd Quarter	.0325	19.13	15.63
3rd Quarter	.0325	19.13	15.25
4th Quarter	.035	20.88	16.88
1987			
1st Quarter	\$.0325	\$25.13	\$20.50
2nd Quarter	.0325	23.13	18.00
3rd Quarter	.0325	23.25	19.38
4th Quarter	.0325	21.25	11.75

As of January 26, 1989, there were 5,953 holders of record of the Company's common stock.



**Southwest Airlines Co.**  
**CONSOLIDATED BALANCE SHEET**

(in thousands except share and per share amounts)

December 31,  
1988                      1987

Assets

Current assets:

Cash and cash equivalents	\$ 209,983	\$ 142,734
Accounts receivable	37,045	44,116
Inventories of parts and supplies, at cost	8,790	7,693
Prepaid expenses and other current assets	9,211	6,577
Total current assets	265,029	201,120

Property and equipment, at cost (Notes 3, 5 and 6):

Flight equipment	1,126,474	858,713
Ground property and equipment	124,840	106,465
Deposits on flight equipment purchase contracts	109,742	134,726
	1,361,056	1,099,904
Less allowance for depreciation	325,088	275,546
	1,035,968	824,358

Other assets	7,392	17,162
	<u>\$1,308,389</u>	<u>\$1,042,640</u>

Liabilities And Stockholders' Equity

Current liabilities:

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Accounts payable	\$ 35,286	\$ 26,877
Accrued liabilities (Note 4)	76,165	56,993
Air traffic liability	27,059	11,540
Income taxes payable	4,408	7,230
Current maturities of long-term debt	9,986	9,743
Total current liabilities	152,904	112,383

Long-term debt, less current maturities (Note 5)	369,541	251,130
Deferred income taxes	101,374	85,918
Deferred gains from sale and leaseback of aircraft	115,314	77,668
Other deferred liabilities	1,881	1,263

Commitments and contingencies (Notes 2, 3 and 6)

Stockholders' equity (Note 7):

Common stock, \$1.00 par value; 100,000,000 shares authorized; 32,254,269 shares issued	32,254	32,254
Capital in excess of par value	175,170	175,170
Retained earnings	374,211	320,402
	581,635	527,826
Less treasury stock, at cost (995,800 shares in 1988; 950,700 shares in 1987)	14,260	13,548
Total stockholders' equity	567,375	514,278

	<u>\$1,308,389</u>	<u>\$1,042,640</u>
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See accompanying notes.



**Southwest Airlines Co.**  
**CONSOLIDATED STATEMENT OF INCOME**

(in thousands except per share amounts)

	Years ended December 31,		
	1988	1987	1986
Operating revenues:			
Passenger	\$828,343	\$751,649	\$742,287
Freight	14,433	13,428	13,621
Other	17,658	13,251	12,882
Total operating revenues	860,434	778,328	768,790
Operating expenses:			
Salaries, wages and benefits (Note 8)	255,046	222,461	207,158
Fuel and oil	130,321	140,334	129,522
Maintenance materials and repairs	54,208	59,469	49,181
Agency commissions	53,063	47,444	44,209
Aircraft rentals	22,629	22,001	7,976
Landing fees and other rentals	40,441	38,860	36,617
Depreciation (Note 12)	66,169	65,484	67,465
Other operating expenses	152,577	151,828	137,699
Total operating expenses	774,454	747,881	679,827
Operating income	85,980	30,447	88,963
Other expenses (income):			
Interest expense	29,209	30,682	37,310
Capitalized interest	(9,279)	(8,066)	(7,069)
Interest income	(10,970)	(7,028)	(2,765)
Net gains on disposals of TranStar assets less provision for operating losses during shut-down period (Note 2)	—	(10,181)	—
Nonoperating gains, net (Note 9)	(8,340)	(4,033)	(3,959)
Total other expenses (income)	620	1,374	23,517
Income before income taxes	85,360	29,073	65,446
Provision for income taxes (Note 10)	27,408	8,918	15,411
Net income	\$ 57,952	\$ 20,155	\$ 50,035
Net income per common share (Note 11)	\$1.84	\$.63	\$1.55

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See accompanying notes.



**Southwest Airlines Co.**  
**CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY**

Three years ended December 31, 1988

(in thousands except per share amounts)

	Common stock	Capital in excess of par value	Retained earnings	Treasury stock	Total
Balance at December 31, 1985	\$32,254	\$175,166	\$258,584	\$ —	\$466,004
Proceeds from issuance of common stock	—	4	—	—	4
Cash dividends, \$.13 per share	—	—	(4,193)	—	(4,193)
Net income — 1986	—	—	50,035	—	50,035
Balance at December 31, 1986	32,254	175,170	304,426	—	511,850
Purchase of treasury stock	—	—	—	(13,627)	(13,627)
Issuance of treasury stock upon exercise of stock options	—	—	(14)	79	65
Cash dividends, \$.13 per share	—	—	(4,165)	—	(4,165)
Net income — 1987	—	—	20,155	—	20,155
Balance at December 31, 1987	32,254	175,170	320,402	(13,548)	514,278
Purchase of treasury stock	—	—	—	(712)	(712)
Cash dividends, \$.1325 per share	—	—	(4,143)	—	(4,143)
Net income — 1988	—	—	57,952	—	57,952
Balance at December 31, 1988	<u>\$32,254</u>	<u>\$175,170</u>	<u>\$374,211</u>	<u>\$ (14,260)</u>	<u>\$567,375</u>

See accompanying notes.



**Southwest Airlines Co.**  
**CONSOLIDATED STATEMENT OF CASH FLOWS**

(in thousands)

	Years ended December 31,		
	1988	1987	1986
Cash flows from operating activities:			
Net income	\$ 57,952	\$ 20,155	\$ 50,035
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	66,169	65,484	67,465
Deferred income taxes	15,456	(2,785)	14,058
Amortization of deferred gains on sale and leaseback of aircraft	(4,444)	(2,670)	—
Gains from sales of TranStar assets (Note 2)	—	(31,824)	—
Gains from sale and leaseback of aircraft (Note 9)	(5,552)	—	—
Changes in certain assets and liabilities:			
Decrease (increase) in accounts receivable	7,071	(10,603)	(1,649)
Decrease (increase) in other current assets	(3,731)	5,374	(2,910)
Increase (decrease) in accounts payable and accrued liabilities	27,581	21,825	6,873
Increase (decrease) in air traffic liability	15,519	3,672	3,640
Increase (decrease) in other current liabilities	(2,579)	4,074	421
Other	4,203	2,449	1,791
Net cash provided by operating activities	177,645	75,151	139,724
Cash flows from investing activities:			
Purchases of property and equipment	(264,531)	(235,040)	(195,028)
Proceeds from sales of TranStar assets (Note 2)	—	163,102	—
Proceeds from sales of other property and equipment	1,176	1,005	13,265
Net cash used in investing activities	(263,355)	(70,933)	(181,763)
Cash flows from financing activities:			
Proceeds from sale and leaseback transactions	158,750	178,000	99,387
Proceeds from (aquisition of) note receivable	9,533	(9,533)	—
Proceeds from issuance of long-term obligations	—	—	101,043
Purchase of treasury stock	(712)	(13,627)	—
Payment of long-term debt and capital lease obligations	(9,743)	(84,050)	(142,235)
Payment of cash dividends	(4,143)	(4,165)	(4,193)
Other	(726)	(2,970)	(6,401)
Net cash provided by financing activities	152,959	63,655	47,601
Net increase in cash and cash equivalents	67,249	67,873	5,562
Cash and cash equivalents at beginning of year	142,734	74,861	69,299
Cash and cash equivalents at end of year	\$209,983	\$142,734	\$ 74,861
Cash payments for:			
Interest, net of amount capitalized	\$ 14,645	\$ 23,525	\$ 27,256
Income taxes	14,774	5,826	—
Financing activities not affecting cash:			
Capital lease obligations incurred	\$124,123	\$ —	\$ —

See accompanying notes.



**Southwest Airlines Co.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
December 31, 1988

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Basis of presentation** The consolidated financial statements include the accounts of Southwest Airlines Co. (Southwest) and its wholly owned subsidiaries, TranStar Airlines Corporation (TranStar), Southwest Jet Fuel Co. and Southwest Airlines Eurofinance N.V. (collectively referred to as the Company). All significant intercompany balances and transactions have been eliminated. The decision was made to discontinue TranStar's operations effective July 1987 as described in Note 2. Accordingly, the results of TranStar's operations subsequent to that date were included in "Other expenses (income)" in the caption "Net gains on disposals of TranStar assets less provision for operating losses during shut-down period." Certain reclassifications of amounts previously reported in the financial statements at December 31, 1987 and 1986 have been made to conform with the presentation at December 31, 1988.

**Statement of cash flows** As of December 31, 1988, the Company adopted Statement of Financial Accounting Standards No. 95, "Statement of Cash Flows," which requires a statement of cash flows in place of a statement of changes in financial position. The consolidated statement of changes in financial position for the years ended December 31, 1987 and 1986 has been restated to conform with the 1988 presentation.

**Short-term investments** that are highly liquid and have original maturity dates of three months or less are considered cash equivalents for purposes of the statement of cash flows.

**Inventories** Inventories of flight equipment expendable parts, materials and supplies are valued at cost. These parts are charged to expense when issued for use.

**Property and equipment** Depreciation is provided by the straight-line method to residual values over periods ranging from 15 to 20 years for flight equipment and three to 30 years for ground property and equipment. The Company charges aircraft maintenance costs to operations as incurred. Property under capital leases and related obligations are recorded at an amount equal to the present value of future minimum lease payments computed on the basis of the lessee's incremental borrowing rate or, when known, the interest rate implicit in the lease. Property under capital leases is amortized on a straight-line basis over the lease term.

**Investment tax credits** Investment tax credits are accounted for by the flow-through method.

**Revenue recognition** Passenger revenue is recognized when the transportation is provided. Tickets sold but not yet used are included in "Air traffic liability."

**2. TRANSTAR**

Effective June 30, 1985, Southwest acquired the stock of Muse Air Corporation, which was subsequently renamed TranStar, for approximately \$68 million consisting of approximately \$40.5 million in cash; 830,320 shares of Southwest common stock; and 1,080,320 warrants to purchase Southwest common stock at \$35 per share, subject to adjustment, expiring on June 25, 1990. The acquisition was accounted for as a purchase and, accordingly, the results of operations of TranStar were included in the consolidated financial statements from the date of acquisition.

Due to substantial operating losses, TranStar's management decided in July 1987 to cease operations and liquidate TranStar's assets and liabilities. Accordingly, the effects of this decision were recorded as of July 1. Since July 1987, TranStar discontinued its scheduled airline operations; sold all its owned aircraft and related spare parts and equipment; assigned its rights and obligations as lessee with respect to all leased aircraft; and effected a nontaxable liquidating dividend of remaining net assets to Southwest at December 31, 1987 and thus, ceased all operations. Proceeds pursuant to these aircraft sale agreements were \$77.8 million in cash and assumption of all aircraft-related debt (\$25.8 million face value of notes and \$50 million face value of Equipment Trust Certificates) and all aircraft-related lease obligations. TranStar also sold its delivery positions for two MD-80 aircraft for cash and assumption of debt equivalent to progress payments made by TranStar on the positions (\$8 million). TranStar remains secondarily liable on the Equipment Trust Certificates and certain of the lease agreements assigned. Ultimately, aircraft should be available, if necessary, to satisfy a substantial portion of the Company's secondary liabilities.

Operating results for TranStar included in the Company's consolidated financial statements for the years ended December 31 were (in thousands):

	1987	1986
Operating revenues	\$ 80,499	\$149,943
Operating expenses	(91,233)	(142,216)
Other expenses, net	(4,451)	(6,061)
Net gains on asset disposals	31,824	—
Provision for operating losses during shut-down period	(21,643)	—
Income (loss) before income taxes	\$ (5,004)	\$ 1,666



### 3. COMMITMENTS

At December 31, 1988, the Company's contractual commitments consisted primarily of scheduled aircraft acquisitions. Nine 737-300s were scheduled for delivery in 1989 and three each in 1991 and 1992. Ten 737-500s were scheduled for delivery in 1990 and five in 1991. In addition, the Company had options to purchase six 737-300s in 1993-1994 and up to 35 737-500s in 1991-1994. Aggregate funding needed for these commitments was approximately \$489.1 million at December 31, 1988 due as follows: \$160.1 million in 1989, \$159.5 million in 1990, \$120.7 million in 1991 and \$48.8 million in 1992.

### 4. ACCRUED LIABILITIES

(in thousands)	1988	1987
Aircraft rentals	\$ 18,339	\$ 13,313
Vacation pay	10,644	8,147
Profit sharing (Note 8)	9,940	1,596
Taxes, other than income	8,356	8,764
Interest	7,662	8,040
Other	21,224	17,133
	<u>\$ 76,165</u>	<u>\$ 56,993</u>

### 5. LONG-TERM DEBT

(in thousands)	1988	1987
9% Notes due 1996	\$100,000	\$100,000
6¾% Convertible Subordinated Debentures due 1998	35,000	35,000
French Export Credit Agreement	12,626	15,151
10.4% ETCs due July 1, 1994	10,748	12,539
10.3% ETCs due January 1, 1995	9,101	10,501
10.3% ETCs due July 1, 1995	10,355	11,834
Capital leases (Note 6)	197,337	70,891
Industrial Revenue Bonds	3,475	4,025
Other	1,494	1,626
	<u>380,136</u>	<u>261,567</u>
Less current maturities	9,986	9,743
Less debt discount	609	694
	<u>\$369,541</u>	<u>\$251,130</u>

In March 1986, Southwest issued \$100 million of unsecured 9% Notes due March 1, 1996. Interest is payable semi-annually on March 1 and September 1 and the entire principal balance is payable at maturity. The Notes are redeemable at the issuer's option on or after March 1, 1993 at par plus accrued interest.

The 6¾% Convertible Subordinated Debentures were issued by Southwest Airlines Eurofinance N.V. and are convertible into common stock at any time on or before July 1, 1998, unless previously redeemed, at a conversion price of \$38.30 per share, subject to adjustment in certain events. Interest is payable on July 1 of each year. The debentures are redeemable at the issuer's option at prices beginning at 103% of face value after July 1, 1986, and declining by 1% per year to 100% in 1989 and thereafter.

The French Export Credit Agreement requires 16 semi-annual installments of principal and interest. The debt is secured by one 737-300 and one 737-200 aircraft and bears interest at 10.5% per annum.

The 10.3% and 10.4% Equipment Trust Certificates require semi-annual principal and interest payments and are secured by 10 737-200 advanced series aircraft with a net book value of approximately \$40 million at December 31, 1988.

The Industrial Revenue Bonds mature in series annually through 1994. Interest is payable semi-annually on January 1 and July 1 at an effective rate of 60% of prime but not less than 7½% or more than 15%. The Bonds are secured by Southwest's Reservations Center in San Antonio.

In addition to the credit facilities described above, Southwest has a Bank Credit Agreement with a group of domestic banks that permits Southwest to borrow through December 18, 1991 on a revolving credit basis up to the primary commitment (\$45 million at December 31, 1988). The primary commitment can be increased to as much as \$170 million at Southwest's option. Interest rates on borrowings under the Credit Agreement can be, at the option of Southwest, the agent bank's prime rate, ¾% over LIBOR or ¾% over domestic certificate of deposit rates. The commitment fee is ¼% per annum on the unused portion of the primary commitment and ⅛% per annum on the difference between \$170 million and the amount of the primary commitment. There were no outstanding borrowings under this agreement at December 31, 1988 or 1987.

Long-term debt principal payments, excluding capital leases, due in the next five years are (in thousands):

1989	\$7,878
1990	9,130
1991	7,820
1992	7,845
1993	7,895



## 6. LEASES

Total rental expense for operating leases charged to operations in 1988, 1987 and 1986 was \$43,435,000, \$41,713,000 and \$27,851,000, respectively. The majority of the Company's corporate office and terminal operations space, as well as 14 aircraft, were under operating leases. The amounts applicable to capital leases included in property and equipment were (in thousands):

	1988	1987
Flight equipment	\$196,505	\$ 72,382
Less accumulated amortization	<u>18,653</u>	<u>12,451</u>
	<u>\$177,852</u>	<u>\$ 59,931</u>

At December 31, 1988, obligations under capital leases and non-cancelable operating leases for future minimum lease payments were (in thousands):

	Capital leases	Operating leases
1989	\$ 12,696	\$ 37,375
1990	23,608	36,367
1991	17,660	35,977
1992	18,508	33,328
1993	19,824	29,880
After 1993	<u>320,702</u>	<u>399,202</u>
Total minimum lease payments	412,998	<u>\$572,129</u>
Less amount representing interest	<u>215,661</u>	
Present value of minimum lease payments	197,337	
Less current portion	<u>2,108</u>	
Long-term portion	<u>\$195,229</u>	

## 7. COMMON STOCK

At December 31, 1988, the Company had 36,700,712 shares of common stock reserved for issuance upon the conversion of convertible securities and pursuant to employee profit sharing and stock option plans and upon exercise of rights pursuant to the Common Share Purchase Rights Plan (the Plan).

Pursuant to the Plan, each outstanding share of the Company's common stock is accompanied by one common share purchase right (Right). Each Right entitles its holder to purchase one share of common stock for \$75 and is exercisable only in the event of a proposed takeover, as defined by the Plan. The Company may redeem the Rights at \$.05 per Right prior to the time that 20 percent of the common stock has been acquired by a person or group. If the Company is acquired or if certain self-dealing transactions occur, as defined in the Plan, each Right

will entitle its holder to purchase for \$75 that number of the acquiring company's or the Company's common shares, as provided in the Plan, having a market value of \$150. The Rights will expire no later than July 30, 1996.

## 8. EMPLOYEE PROFIT SHARING PLAN

Substantially all of the Company's employees are members of the Southwest Airlines Co. Profit Sharing Plan (the Plan). Total profit sharing expense charged to operations in 1988, 1987 and 1986 was \$9,931,000, \$1,596,000 and \$8,469,000, respectively. The Plan provides that Southwest may contribute, as determined by the board of directors, the lesser of 15% of its adjusted pretax income (as defined by the Plan) or the maximum amount deductible for federal income tax purposes.

## 9. NONOPERATING GAINS

In 1988, gains of \$5,552,000 were recognized on the sale and subsequent short-term leaseback of three 737-200 aircraft. The Company realized gains of \$3,608,000 in 1988 and \$4,297,000 in 1987 from sales of certain financial assets. The Company sold aircraft delivery positions in 1986, realizing a gain of \$3,959,000.

## 10. INCOME TAXES

The provision for income taxes included deferred taxes resulting from timing differences in the recognition of revenue and expense for financial and tax reporting purposes. The provision for income taxes consisted of (in thousands):

	1988	1987	1986
Current	\$11,952	\$11,703	\$ 1,353
Deferred:			
Depreciation	14,361	5,600	30,284
Deferred gains on sale/leaseback	(14,326)	(17,635)	(9,424)
Net operating loss utilized	9,999	10,015	3,753
Investment tax credits	6,640	1,671	(8,251)
Vacation pay	(1,176)	—	—
Other	(42)	(2,436)	(2,304)
Total deferred provision (benefit)	<u>15,456</u>	<u>(2,785)</u>	<u>14,058</u>
Total	<u>\$27,408</u>	<u>\$ 8,918</u>	<u>\$15,411</u>



The provision for income taxes differed from the amount that resulted from applying the statutory federal income tax rates (34% in 1988, 40% in 1987 and 46% in 1986) to income before income taxes as follows (in thousands):

	1988	1987	1986
Federal income tax provision			
at statutory rate	\$29,022	\$11,629	\$30,105
Investment tax credit	(3,415)	(8,193)	(11,089)
Effect of TranStar basis differences that resulted from purchase accounting adjustments	—	4,008	(1,554)
Nondeductible expenses	503	785	—
State income tax provision, net of federal benefit	1,272	360	—
Other tax credits	—	—	(754)
Capital gains	—	—	(740)
Other	26	329	(557)
	<u>\$27,408</u>	<u>\$ 8,918</u>	<u>\$15,411</u>

The effect of the discontinuance of TranStar's operations (described in Note 2) was to increase the provision for income taxes for the year ended December 31, 1987 by \$7 million. As a result of the application of Accounting Principles Board Opinion No. 16 (APB 16) upon the acquisition of TranStar in 1985, large permanent differences existed between the bases of the aircraft for federal income tax purposes versus the net book values for financial reporting purposes. Therefore, the gains from the sales of these assets for federal income tax purposes were significantly greater than the corresponding gains for financial reporting purposes and thus, the provision for income taxes applicable to TranStar's pretax earnings of \$10,181,000 derived during the shut-down period was approximately 69%.

Further, the discontinuance of TranStar's operations and its subsequent liquidation enabled the Company to realize in 1987, for financial reporting purposes, the purchased TranStar net operating loss and investment tax credit carryforwards of approximately \$52.2 million and \$3.5 million, respectively.

At December 31, 1988, the Company had available \$16.7 million in credit carryforwards for federal income tax purposes. The carryforwards will expire in 1999 through 2003 if not previously utilized.

#### 11. NET INCOME PER COMMON SHARE

Net income per common share is computed based on the weighted average number of common and common equivalent shares outstanding (31,466,000 in 1988, 32,091,000 in 1987 and 32,254,000 in 1986).

Net income per common share assuming full dilution is computed based on shares issuable upon conversion of debentures (weighted for number of days outstanding) and the weighted average number of common and common equivalent shares outstanding (32,389,000 in 1988, 33,005,000 in 1987 and 33,168,000 in 1986). The computation includes adjustment of \$1,559,000 in 1988, \$1,418,000 in 1987 and \$1,276,000 in 1986 for debenture interest expense, net of income tax effect.

#### 12. DEPRECIATION

Effective July 1, 1988, Southwest changed the estimated useful life for depreciation purposes of its 737-300 aircraft from 18 to 20 years. In addition, the estimated residual value for all aircraft was changed from 10% to 15%. The effect of these changes was to reduce depreciation expense approximately \$3.3 million for 1988.



## REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS

The Board of Directors  
Southwest Airlines Co.

We have audited the accompanying consolidated balance sheet of Southwest Airlines Co. at December 31, 1988 and 1987, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 1988. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Southwest Airlines Co. at December 31, 1988 and 1987, and the consolidated results of operations and cash flows for each of the three years in the period ended December 31, 1988, in conformity with generally accepted accounting principles.



Dallas, Texas  
January 27, 1989



**Southwest Airlines Co.**  
**SUPPLEMENTARY INFORMATION**  
**PARENT COMPANY ONLY**

**SUMMARY OF OPERATIONS**

(in thousands)

Years ended December 31,

	1988	1987	1986
Operating revenues:			
Passenger	\$828,343	\$675,397	\$599,440
Freight	14,433	12,329	11,758
Other	17,658	10,937	8,501
Total operating revenues	860,434	698,663	619,699
Operating expenses:			
Salaries, wages and benefits	255,046	206,140	179,269
Fuel and oil	130,321	121,900	99,702
Maintenance materials and repairs	54,208	52,331	40,316
Agency commissions	53,063	40,498	32,520
Aircraft rentals	22,629	14,834	858
Landing fees and other rentals	40,441	33,593	27,569
Depreciation	66,169	59,139	55,644
Other operating expenses	152,577	129,047	102,585
Total operating expenses	774,454	657,482	538,463
Operating income	85,980	41,181	81,236
Other expenses, net	620	7,104	17,456
Equity in earnings (loss) of TranStar	—	(5,004)	1,666
Income before income taxes	85,360	29,073	65,446
Provision for income taxes	27,408	8,918	15,411
Net income	\$ 57,952	\$ 20,155	\$ 50,035

**OPERATING STATISTICS**

	1988	1987	1986
Revenue passengers carried	14,876,582	12,313,114	11,333,893
RPMs (000s)	7,676,257	6,749,942	5,666,037
ASMs (000s)	13,309,044	11,456,730	9,712,384
Load factor	57.7%	58.9%	58.3%
Average length of passenger haul	516	548	500
Trips flown	274,859	246,046	218,841
Average passenger fare	\$55.68	\$54.85	\$52.89
Passenger revenue yield per RPM	10.79¢	10.01¢	10.58¢
Operating revenue yield per ASM	6.47¢	6.10¢	6.38¢
Operating expenses per ASM	5.82¢	5.74¢	5.54¢
Fuel cost per gallon (average)	51.37¢	54.88¢	51.58¢
Number of employees at year-end	6,467	5,765	4,610
Size of fleet at year-end*	85	75	63

\*includes leased aircraft

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# Southwest Airlines Co.

## TEN YEAR SUMMARY

### SELECTED CONSOLIDATED FINANCIAL DATA

(in thousands except per share amounts)

	1988	1987	1986	1985 (5)
Operating revenues:				
Passenger	\$ 828,343	\$ 751,649	\$ 742,287	\$ 656,689
Freight	14,433	13,428	13,621	13,643
Other	17,658	13,251	12,882	9,340
Total operating revenues	860,434	778,328	768,790	679,672
Operating expenses	774,454	747,881	679,827	601,148
Operating income	85,980	30,447 (2)	88,963	78,524
Other expense (income), net	620 (1)	1,374 (3)	23,517 (4)	17,740
Income before income taxes	85,360	29,073	65,446	60,784
Provision for income taxes	27,408	8,918	15,411	13,506
Net income	\$ 57,952	\$ 20,155	\$ 50,035	\$ 47,278
Net income per common share:				
Primary	\$ 1.84	\$ .63	\$ 1.55	\$ 1.54
Fully diluted	\$ 1.84	\$ .63	\$ 1.55	\$ 1.51
Cash dividends per common share	\$ .1325	\$ .13	\$ .13	\$ .13
Total assets	\$ 1,308,389	\$ 1,042,640	\$ 1,061,419	\$ 1,002,403
Long-term obligations	\$ 369,541	\$ 251,130	\$ 339,069	\$ 381,308
Stockholders' equity	\$ 567,375	\$ 514,278	\$ 511,850	\$ 466,004

### F16 CONSOLIDATED FINANCIAL RATIOS

Return on average total assets	5.1%	1.9%	4.8%	5.6%
Return on average stockholders' equity	10.8%	4.0%	10.3%	11.4%
Debt as a percentage of invested capital	39.4%	32.8%	39.8%	45.0%

### CONSOLIDATED OPERATING STATISTICS

Revenue passengers carried	14,876,582	13,503,242	13,637,515	12,651,239
RPMs (000s)	7,676,257	7,789,376	7,388,401	5,971,400
ASMs (000s)	13,309,044	13,331,055	12,574,484	9,884,526
Load factor	57.7%	58.4%	58.8%	60.4%
Average length of passenger haul	516	577	542	472
Trips flown	274,859	270,559	262,082	230,227
Average passenger fare	\$55.68	\$55.66	\$54.43	\$51.91
Passenger revenue yield per RPM	10.79¢	9.65¢	10.05¢	11.00¢
Operating revenue yield per ASM	6.47¢	5.84¢	6.11¢	6.88¢
Operating expenses per ASM	5.82¢	5.61¢	5.41¢	6.08¢
Fuel cost per gallon (average)	51.37¢	54.31¢	51.42¢	78.17¢
Number of employees at year-end	6,467	5,765	5,819	5,271
Size of fleet at year-end (7)	85	75	79	70

(1) Includes \$5.5 million gain on sales of aircraft and \$3.6 million from the sale of certain financial assets

(2) Includes TranStar's results through June 30, 1987

(3) Includes \$10.1 million net gains from the discontinuance of TranStar's operations and \$4.3 million from the sale of certain financial assets

(4) Includes a gain of \$4 million from the sale of aircraft delivery positions

(5) Includes the accounts of TranStar since June 30, 1985

(6) Includes a gain from the sale of tax benefits relating to three aircraft of \$11 million

(7) Includes leased aircraft



1984	1983	1982	1981	1980	1979
\$ 519,106	\$ 433,388	\$ 317,996	\$ 258,612	\$ 204,260	\$ 130,507
12,115	10,357	9,469	8,326	6,080	4,057
4,727	4,491	3,724	3,420	2,708	1,550
535,948	448,236	331,189	270,358	213,048	136,114
467,451	379,738	291,964	221,854	164,219	107,128
68,497	68,498	39,225	48,504	48,829	28,986
649	4,927	(5,165) (6)	239	7,539	8,272
67,848	63,571	44,390	48,265	41,290	20,714
18,124	22,704	10,386	14,100	12,843	4,062
\$ 49,724	\$ 40,867	\$ 34,004	\$ 34,165	\$ 28,447	\$ 16,652
\$ 1.69	\$ 1.40	\$ 1.28	\$ 1.35	\$ 1.30	\$ .79
\$ 1.64	\$ 1.38	\$ 1.26	\$ —	\$ —	\$ —
\$ .13	\$ .13	\$ .13	\$ .11	\$ .09	\$ .06
\$ 646,244	\$ 587,258	\$ 420,542	\$ 291,823	\$ 224,442	\$ 172,495
\$ 153,314	\$ 158,701	\$ 106,306	\$ 58,934	\$ 77,892	\$ 87,374
\$ 361,768	\$ 314,556	\$ 240,627	\$ 176,503	\$ 106,964	\$ 58,412

8.1%	8.1%	9.6%	13.0%	14.1%	11.7%
14.7%	14.2%	16.7%	23.5%	36.0%	33.1%
29.8%	33.5%	30.6%	25.0%	42.1%	59.9%

10,697,544	9,511,000	7,965,554	6,792,927	5,976,621	5,000,086
4,669,435	3,893,821	3,022,142	2,310,181	2,024,097	1,585,539
7,983,093	6,324,224	4,907,945	3,633,351	2,969,448	2,320,371
58.5%	61.6%	61.6%	63.6%	68.2%	68.3%
436	409	379	340	339	317
200,124	175,421	140,030	110,301	91,143	75,837
\$48.53	\$45.57	\$39.92	\$38.07	\$34.18	\$26.10
11.12¢	11.13¢	10.52¢	11.19¢	10.09¢	8.23¢
6.71¢	7.09¢	6.75¢	7.44¢	7.17¢	5.87¢
5.86¢	6.00¢	5.95¢	6.11¢	5.53¢	4.62¢
82.44¢	85.92¢	94.51¢	101.67¢	84.49¢	59.35¢
3,934	3,462	2,913	2,129	1,839	1,630
54	46	37	27	23	18



## CORPORATE DATA

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### TRANSFER AGENT AND REGISTRAR

MTrust Corp., N.A.  
P.O. Box 2320  
Dallas, Texas 75221-2320

### STOCK EXCHANGE LISTING

New York Stock Exchange  
Ticker Symbol: LUV

### AUDITORS

Arthur Young & Company  
Dallas, Texas

### GENERAL OFFICES

P.O. Box 37611  
Love Field  
Dallas, Texas 75235-1625

### ANNUAL MEETING

The Annual Meeting of Shareholders of Southwest Airlines Co. will be held at 10:00 a.m. on May 17, 1989 in the Auditorium of MBank Dallas on the fifth floor of Momentum Place, 1717 Main Street, Dallas, Texas.

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### SEC FORM 10-K

Shareholders may obtain free of charge a copy of the Company's Annual Report on Form 10-K as filed with the Securities and Exchange Commission by writing to the Chief Financial Officer, P.O. Box 37611, Love Field, Dallas, Texas 75235-1625.















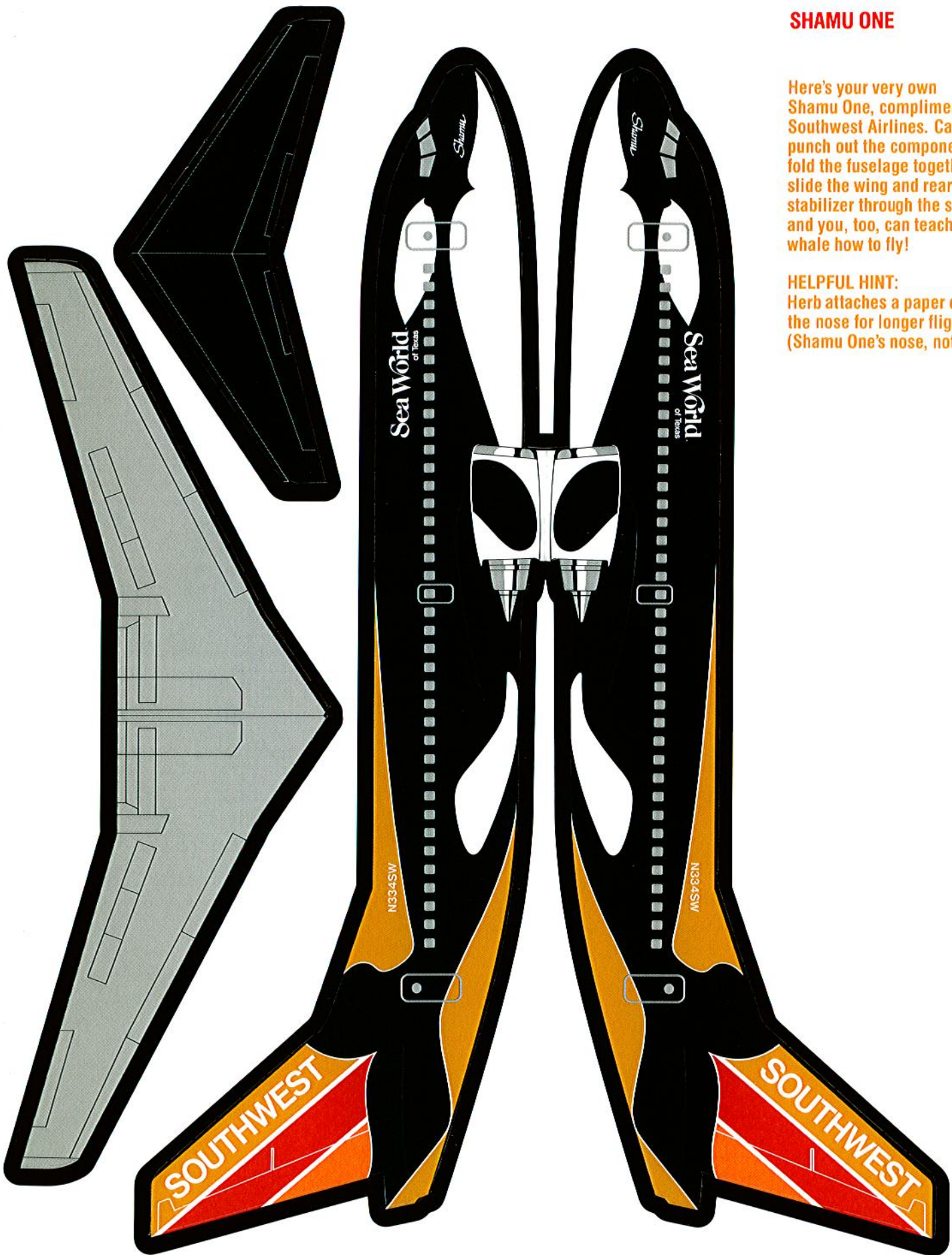




## SHAMU ONE

Here's your very own Shamu One, compliments of Southwest Airlines. Carefully punch out the components, fold the fuselage together, slide the wing and rear stabilizer through the slots, and you, too, can teach a whale how to fly!

**HELPFUL HINT:**  
Herb attaches a paper clip to the nose for longer flights. (Shamu One's nose, not his.)







**Southwest Airlines Co.**

P. O. Box 37611  
Love Field  
Dallas, Texas 75235-1625  
(214) 902-1100