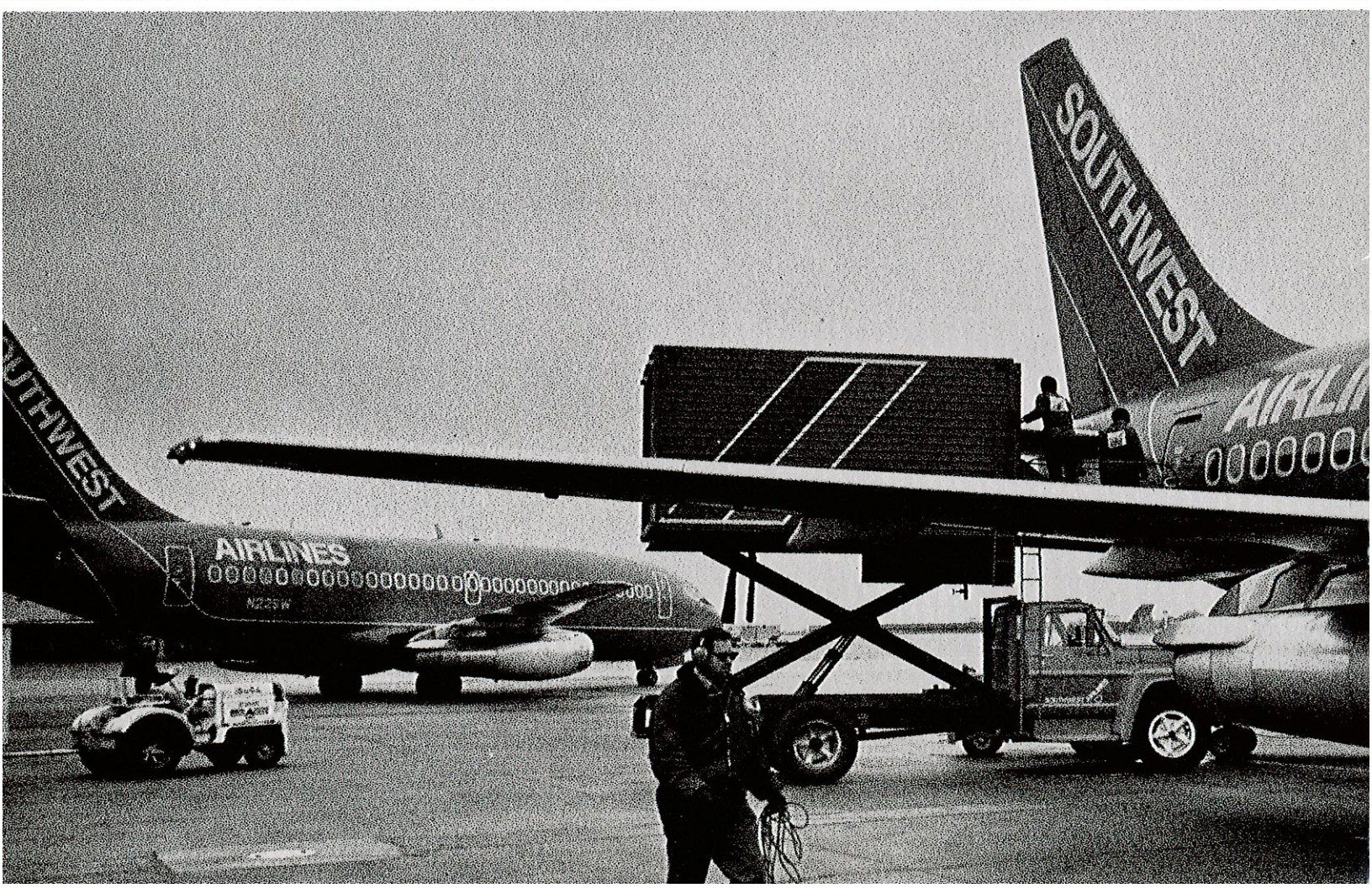
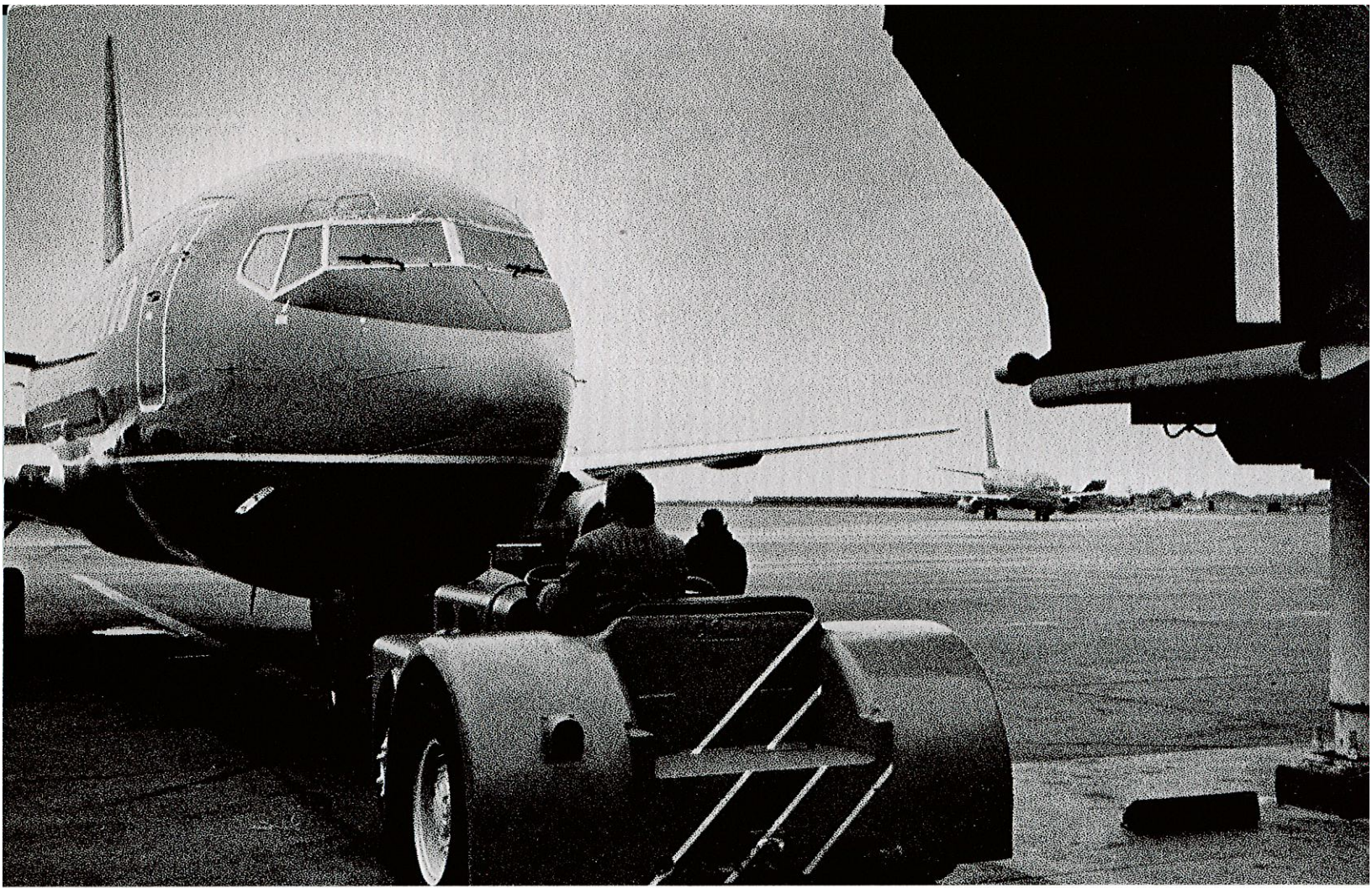


Southwest Airlines Co. Annual Report 1972





To Our Shareholders

As we embark on the year 1973, all trends indicate that Southwest Airlines Co. will operate profitably for the first time. During the six months and 13 days of scheduled intrastate air operations in 1971, the Airline incurred losses of \$2,713,000 after having incurred pre-operating costs of \$1,040,000 between the period January 1 and June 18, 1971, for a combined loss for the year of \$3,753,000 or \$3.54 per outstanding share.

During 1972, improvements in revenue permitted the Company to slash its net loss from operations for the full 12-month period to \$2,124,000. This amount was further reduced by a \$533,000 extraordinary gain on the sale of one of our four Boeing 737-200 aircraft. The resulting net loss for the year of \$1,591,000 is equivalent to \$1.50 per outstanding share.

The Company's step by step progress toward a viable and profitable scheduled intrastate airline operation is set forth in detail in "The Southwest Story" which follows this letter. It is an exciting series of events, actions, and counteractions, and deserves your attention.

DEBT REDUCTION

For some months, your directors and management have been concerned about the Company's imminent responsibility of paying in full the 7% Convertible Promissory Notes due March 10, 1973. Full payment at that time would have seriously affected the Company's available working capital and probably would have triggered the necessity of additional financing through private sources on terms most unfavorable to present shareholders. With this in mind, the Board of Directors authorized management in early

November to make the following alternative offer to our noteholders. They could accept prepayment of the notes on or before December 1, 1972 by considering previous interest payments made and to be made as principal reductions totaling 12.25% of the note's face value with a final payment upon cancellation of the note on or before December 1 of 87.75% of the amount of each such note. Alternatively, noteholders were granted the one-time opportunity to accept, until December 1, 1972, unregistered common stock of the Company at the rate of one share for each \$2 of face value of notes held plus exchange of their 1976 warrants to purchase common stock at \$6.05 per share for 1978 warrants to purchase common stock at \$4.00 per share. At the time of the offer the Company's common stock was trading in the over-the-counter market at $\$2\frac{5}{8}$ bid, $\$2\frac{7}{8}$ asked. As a result, notes with a face value of \$1,150,000 were redeemed for a consideration of \$140,875 less than their face value and notes totaling \$100,000 were exchanged for 50,000 shares of unregistered common stock with 10,000 old 1976 warrants being exchanged for 10,000 new 1978 warrants. The remaining 1976 warrants, representing 115,000 potential shares at \$6.05 each, remain outstanding. The approximate quarter million dollars of cash conserved by this transaction will be extremely useful to the Company in its future operations. At December 31, 1971 our long-term commitments to Boeing Financial Corporation totaled

\$16.8 million. At 1972 year-end this figure has been reduced to \$11.9 million after making interest payments to Boeing of \$861,000. During 1973, our total debt service payments to Boeing Financial Corporation will be approximately \$1,266,000, an amount substantially below our anticipated cash flow from operations.

STATUS OF LEGAL ACTIONS

The question of possible jurisdiction over our intrastate air carrier operations by the Civil Aeronautics Board, a federal agency, as raised by competing carriers in the Federal Circuit Court of Appeals for the District of Columbia, was decided favorably and decisively by that Court on December 11, 1972. Thus, the jurisdiction and authority of the Texas Aeronautics Commission was in no way abridged.

The question of continued scheduled service from Love Field in Dallas after the opening of the Regional Airport in Grapevine, Texas presently is before a Federal District Court in Dallas. Undoubtedly any decision issued in that case will be appealed to higher courts.

Building "something" from "nothing" in the face of devastating competitive forces as well as a less than helpful attitude by the elected and appointed officials of our headquarters city has been no easy task. It could not have been accomplished except for the dedicated efforts and outstanding esprit de corps of our 183 employees as well as the tremendous support of our ever-growing population of loyal customers who utilize at every opportunity the Southwest brand of service in our three Texas markets. The heartfelt thanks of our directors and management go to each of them.

Cordially yours,



M. Lamar Muse
President &
Chief Executive Officer



The Southwest Story

The story of Southwest Airlines' progress toward profitable operations may best be told graphically and is presented on the opposite page. This graph portrays total expense of operations stated as the average number of passengers required to cover fully allocated costs per trip flown in scheduled service. It is divided into significant periods of our development from inception of scheduled service on June 18, 1971 through and including the first quarter of 1973 (incorporating certain estimates). Total costs are segregated in the bar graphs as between cash costs and non-cash costs. The ascending linear graph reflects the actual average passenger loads per trip flown each month since inception of operations (February and March, 1973 estimated).

JUNE 18-SEPTEMBER 30, 1971

During the initial period ended September 30, 1971, Southwest operated three Boeing 737-200 aircraft in the Dallas-Houston and Dallas-San Antonio markets. We carried an overall average of 15.9 passengers per trip flown and generated revenues of roughly half of our cash costs, with no coverage of our non-cash costs consisting of depreciation of equipment, amortization of certification costs, accruals for future aircraft and engine overhaul costs (net), and deferred interest costs. During this period, we offered a basic fare of \$20 in each of our markets; \$7 less in the Houston market and \$8 less in the San Antonio market than the standard coach fares in effect prior to our inaugurating service. These fares were met immediately by our competitors.

OCTOBER, 1971-APRIL, 1972

Effective October 1, 1971, we instituted additional frequencies in the two markets providing an every-hour service in the Dallas-Houston market and every-other hour service in the Dallas-San Antonio market. This became possible with the delivery of our fourth Boeing 737 in late September, 1971. In mid-November, we transferred one-half of our Dallas-Houston service from the distant Intercontinental Airport in Houston to the close-in Hobby Airport and simultaneously inaugurated service between San Antonio and Houston's Hobby Airport, the only such service available. Between October, 1971 and April, 1972, the average passenger loads increased from 18.4 passengers to 26.7 passengers for a seven-month average of 22.2 passengers. This was slightly more than half the total passengers required to cover total costs per trip flown, including non-cash costs.

MAY-JUNE, 1972

In early May, 1972, Southwest consolidated its entire Houston operations at Hobby Airport, thus permitting the disposition of our fourth aircraft. At the same time, Braniff International began providing a competitive service between Dallas and Houston's Hobby Airport with an extensive publicity program. Also in early May, Southwest began experimenting with a nightly flight after 9:00 p.m. in the Dallas-Houston market in both directions and southbound between Dallas and San Antonio on which all seats were priced at \$10. Its success and substantial contribution to our breakeven requirement were almost immediate, and thus the

average passenger loads during this two-month period increased to 29.7 passengers.

JULY-OCTOBER, 1972

In early July, 1972, our basic one-way fare was increased from \$20 to \$26 with a roundtrip fare of \$50. The new roundtrip fare was still \$4 less in the Dallas-Houston market and \$6 less in the Dallas-San Antonio market than the roundtrip coach fares in effect prior to Southwest entering the markets. The four-month period ended in October, 1972 represented the only flat period of growth in the Company's operating history. To some extent this was due to the fare increase, but more importantly to the substantial expansion in early July of Braniff's service to Houston's Hobby Airport as well as the historic drop-off of business travel in these commuter markets during the summer. Our average passenger load increased only one passenger per flight to 30.7 passengers, which was fractionally in excess of the average loads required to cover all cash costs during that period.

CHANGE IN PHILOSOPHY

As it has subsequently developed, October 30, 1972 was an historic date for Southwest Airlines for it was that day we put into effect the results of our previous experience and testing of the markets we serve. Prior to beginning scheduled operations, we had forecast that during our first year of operations at the reduced \$20 fare we would expand the market over the year 1970 by 68%. By June, 1972, our anniversary month, the total market had expanded only 53%, with a somewhat lower percentage for the full first year. It

was determined that the \$20 fare had been just a windfall for the business-oriented traffic which required high frequency service throughout each of the five business days each week, with no corresponding increase in this price inelastic market; and the \$20 fare was too far removed from the cost of non-stop bus and personal car travel to expand effectively that very price elastic market.

NOVEMBER, 1972-JANUARY, 1973

The problem of excessively low fares for the inelastic business travel market had been corrected in early July, 1972; it was now time to put on a solid basis an attractive package for the non-business traveler who is extremely price conscious. We did this by instituting a very usable schedule of half-fare flights (\$13 one-way, \$25 roundtrip) in both directions of our two principal markets each weekday night at 8:00 p.m. or

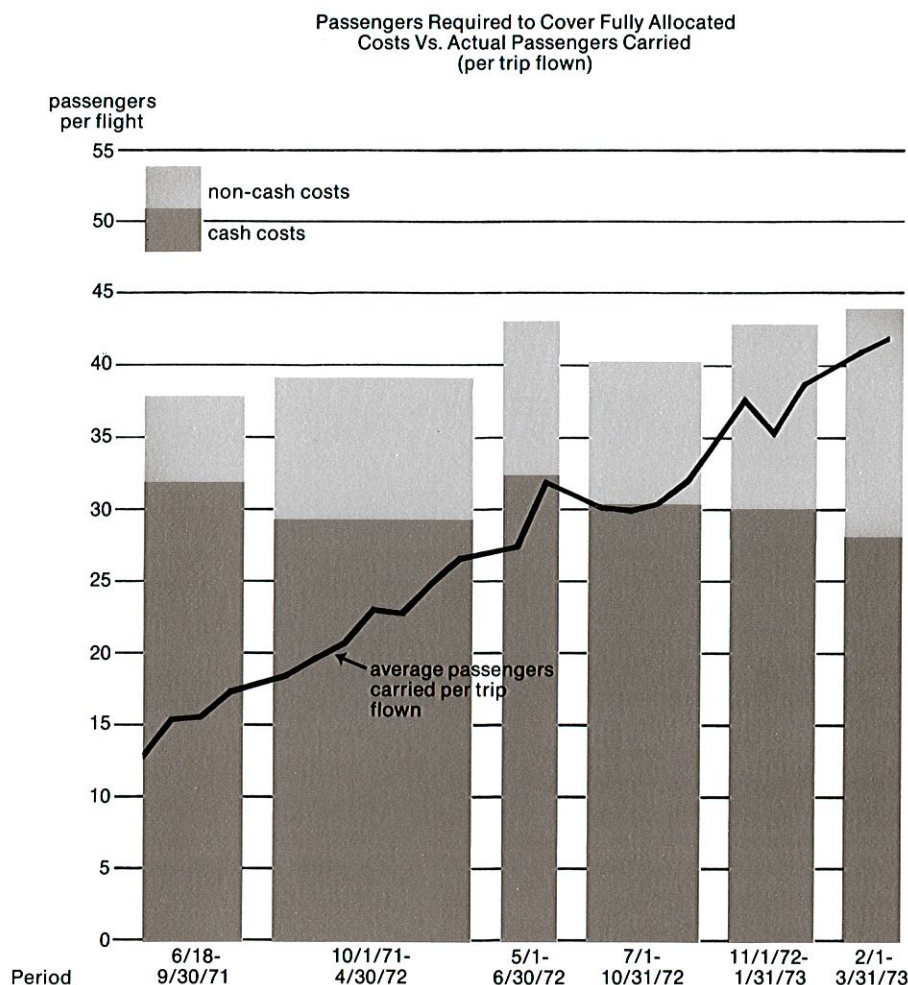
after; reinstituting a Saturday schedule which had been abandoned for lack of traffic in November, 1971; and making *all* weekend flights available at the single price of \$13 one-way and \$25 roundtrip. An intensive three-week advertising campaign accompanied this new schedule and pricing policy change. As a result, November passenger traffic increased over 12% above October, 1972, which month is historically the best month of the year in our commuter markets.

During the November, 1972-January, 1973 period, our average loads increased from 30.7 passengers to 37.5, a 22% increase, which average load was 78% higher than the average passenger loads carried during the corresponding three months one year earlier. Also for the first time the Company experienced very healthy positive cash flows and losses which only a very few additional passengers per flight would

cure. We were, at last, beginning to be able to see over the horizon, in spite of the fact that during this three-month period, existing weather conditions in our operating area were the worst experienced in several decades.

FEBRUARY-MARCH, 1973

Southwest Airlines' largest single remaining problem was the very substantial losses being incurred in our Dallas-San Antonio market. Unlike the Dallas-Houston market, where the Company's hourly schedule pattern is fully competitive, Southwest operates only four trips in each direction each weekday in this market versus seventeen trips by our principal competitor. Therefore, if the businessman uses Southwest regularly, he must plan his business appointments around our schedules, which is the reverse of what most businessmen normally do. Many businessmen have found that the schedule reliability and superior cabin services offered by Southwest make this a worthwhile effort on their part, but not nearly enough to make the market profitable for the Company. Therefore, in late January, 1973, Southwest began a 60-day half-price sale in its Dallas-San Antonio market on all flights operated each day in the market. It was felt this would speed up the trial of Southwest services and conversion of these passengers to Southwest Boosters, thus producing long-range benefits for the Company. The results speak for themselves. February and March average loads are significantly higher than any previous period of Southwest's history and shortly will break out of the bar graphs representing fully allocated costs per trip flown. Net profits from overall operations, not just Dallas-Houston, are our new standard, and we will build from that solid base.





Statement of Operations and Deficit

	YEAR ENDED DECEMBER 31, 1972	JUNE 18, 1971 (DATE OF COMMENCEMENT OF OPERATIONS) TO DECEMBER 31, 1971
Revenues:		
Transportation:		
Passenger	\$5,613,546	\$2,054,381
Other	298,371	78,134
Interest	82,244	104,159
	<u>5,994,161</u>	<u>2,236,674</u>
Expenses:		
Operations and maintenance (Note 1)	3,777,465	2,391,259
Marketing and promotion	896,197	541,710
Insurance and taxes	768,952	394,631
General and administrative	467,512	240,979
Depreciation and amortization (Note 1)	1,337,382	721,726
Cost of borrowed funds (Note 3)	870,464	659,317
	<u>8,117,972</u>	<u>4,949,622</u>
Loss before extraordinary items	2,123,811	2,712,948
Extraordinary items (Note 5)	(532,636)	1,039,675
Net loss	1,591,175	3,752,623
Deficit at beginning of period	3,752,623	—
Deficit at end of period	<u>\$5,343,798</u>	<u>\$3,752,623</u>
Loss per share of common stock (based on average shares outstanding):		
Before extraordinary item	<u>\$2.00</u>	<u>\$2.56</u>
After extraordinary item	<u>\$1.50</u>	<u>\$3.54</u>

See accompanying notes.

Balance Sheet

December 31, 1972 and 1971

Assets

	<u>1972</u>	<u>1971</u>
Current assets:		
Cash	\$ 133,839	\$ 231,530
Certificates of deposit (Note 2)	1,250,000	2,850,000
Accounts receivable:		
Trade	397,664	300,545
Interest	14,691	35,013
Other	<u>67,086</u>	<u>32,569</u>
	479,441	368,127
Less allowance for doubtful accounts	<u>86,363</u>	<u>30,283</u>
	393,078	337,844
Inventories of parts and supplies, at cost	154,121	171,665
Prepaid insurance and other	<u>75,625</u>	<u>156,494</u>
Total current assets	2,006,663	3,747,533
Property and equipment, at cost (Note 1):		
Boeing 737-200 jet aircraft	12,409,772	16,263,250
Support flight equipment	2,423,480	2,378,581
Ground equipment	<u>346,377</u>	<u>313,072</u>
	15,179,629	18,954,903
Less accumulated depreciation and overhaul allowance	<u>2,521,646</u>	<u>1,096,177</u>
	12,657,983	17,858,726
Deferred certification costs less amortization (Note 1)	371,095	477,122
	<u>\$15,035,741</u>	<u>\$22,083,381</u>

See accompanying notes.

Liabilities and Stockholders' Equity

	<u>1972</u>	<u>1971</u>
Current liabilities:		
Notes payable to banks (secured) (Note 2)	\$ 950,000	\$ —
Accounts payable	124,890	355,539
Accrued salaries and wages	55,293	54,713
Other accrued liabilities	136,437	301,244
Long-term debt due within one year (Note 3)	<u>1,226,457</u>	<u>1,500,000</u>
Total current liabilities	2,493,077	2,211,496
Long-term debt due after one year (Note 3):		
7% Convertible Promissory Notes	—	1,250,000
Conditional Purchase Agreements — Boeing Financial Corporation (1½% over prime rate)	<u>11,942,056</u>	<u>16,803,645</u>
	11,942,056	18,053,645
Less amounts due within one year	<u>1,226,457</u>	<u>1,500,000</u>
	10,715,599	16,553,645
Contingencies (Note 7)		
Stockholders' equity (Note 4):		
Common stock, \$1.00 par value, 2,000,000 shares authorized, 1,108,758 issued (1,058,758 at December 31, 1971)	1,108,758	1,058,758
Capital in excess of par value	6,062,105	6,012,105
Deficit	(5,343,798)	(3,752,623)
	<u>1,827,065</u>	<u>3,318,240</u>
	<u>\$15,035,741</u>	<u>\$22,083,381</u>

See accompanying notes.

Statement of Changes in Financial Position

	YEARS ENDED DECEMBER 31,	
	1972	1971
Sources of working capital:		
Issuance of long-term debt	\$ —	\$17,255,859
Common stock issued	100,000	6,640,983
Proceeds from sale of aircraft (Note 5)	4,090,000	—
	<u>4,190,000</u>	<u>23,896,842</u>
Uses of working capital:		
Net additions to property and equipment	78,575	18,945,654
Net reductions in long-term debt	5,902,838	702,214
Pre-operating costs (Note 5)	—	1,039,675
Applied to operations:		
Loss before extraordinary items	2,123,811	2,712,948
Less charges not involving working capital in the period:		
Depreciation provision (Note 1)	(1,231,355)	(668,713)
Overhaul allowance (Note 1)	(490,599)	(427,464)
Amort. of certification costs (Note 1)	(106,027)	(53,014)
Deferred interest expense	(64,792)	—
Total	<u>231,038</u>	<u>1,563,757</u>
	<u>6,212,451</u>	<u>22,251,300</u>
Increase (decrease) in working capital	<u>\$ (2,022,451)</u>	<u>\$ 1,645,542</u>
Changes in components of working capital:		
Increase (decrease) in current assets:		
Cash	\$ (97,691)	\$ 231,347
Certificates of deposit	(1,600,000)	2,850,000
Accounts receivable	55,234	337,744
Inventories	(17,544)	171,665
Prepaid insurance and other	(80,869)	156,463
	<u>(1,740,870)</u>	<u>3,747,219</u>
Increase (decrease) in current liabilities:		
Notes payable (Note 2)	950,000	—
Accounts payable	(230,649)	324,720
Accrued salaries and wages	580	(24,287)
Other accrued liabilities	(164,807)	301,244
Long-term debt due within one year	(273,543)	1,500,000
	<u>281,581</u>	<u>2,101,677</u>
Increase (decrease) in working capital	<u>\$ (2,022,451)</u>	<u>\$ 1,645,542</u>

See accompanying notes.



Notes to Financial Statements

Year Ended December 31, 1972

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Depreciation and overhaul allowances — 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 future major maintenance and overhaul to be performed on its aircraft by accruing a reserve for airworthiness during the current year of \$90.00 for each flight hour. The Company charges against this reserve its actual expenditures for certain aircraft maintenance materials and out-

side repair costs. A net reserve for future period maintenance has been accumulated in the amount of \$790,591 at December 31, 1972. Routine aircraft maintenance inspections are charged to expense as incurred.

Deferred certification costs — Deferred certification costs are being amortized on a straight-line basis over a five year period ending June 30, 1976.

2. CERTIFICATES OF DEPOSIT AND NOTES PAYABLE TO BANKS

Notes payable to banks, secured by certificates of deposit, were paid from the proceeds of such certificates of deposit when they matured in January, 1973.

3. LONG-TERM DEBT

The Company's 7% Convertible Promissory Notes in the amount of \$1,250,000 due March 10, 1973 were retired as of December 1, 1972, through a special alternative offer to the noteholders. As a result, notes with a face value of \$1,150,000 were retired by making cash payments totaling \$1,009,125 equivalent to 87.75% of the face value of such notes. The 12.25% discount is equivalent to the interest which had been paid on those notes from the date of issuance. As the majority of this discount was applicable to 1972, such amount was applied to the

current year's cost of borrowed funds. Notes with a face value of \$100,000 were exchanged into 50,000 shares of the Company's unregistered common stock, \$1.00 par value, at a rate of \$2.00 per share.

At December 31, 1972, the Company owed Boeing Financial Corporation, under the terms of Conditional Purchase Agreements, \$11,942,056 in connection with the purchase of three Boeing 737-200 aircraft together with spare engines, parts, and support and test equipment. The Conditional Purchase Agreements, as amended, provide for total debt service payments in 1973 of \$1,266,000 plus 50% of any net increase in working capital during 1973, before deducting purchases of any property and equipment. Debt service payments, including interest, are \$1,650,000 in 1974 and \$1,800,000 in 1975 and 1976 respectively. The Agreements provide that any balance due at the end of six years (1977) after the delivery of the aircraft shall be paid in full at that time. Interest on the unpaid balance of such debt shall be accrued and/or paid at a rate equivalent to 1½% above the base commercial rate at a specified bank.

4. STOCKHOLDERS' EQUITY

In connection with the exchange

of 50,000 shares of common stock for \$100,000 face amount of notes as mentioned in Note 3, common stock and capital in excess of par value were each increased by \$50,000.

The Company has reserved for issuance on exercise of the 1976 warrants 115,000 shares exercisable at \$6.05 per share and on exercise of the 1978 warrants, 10,000 shares exercisable at \$4.00 per share. The 1978 warrants were issued in exchange for a like number of 1976 warrants in connection with the exchange of common stock for notes mentioned above.

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. EXTRAORDINARY ITEMS

The Company received \$4,090,000 during the current year as a result of the cash sale of one of its four Boeing 737-200 aircraft, less certain equipment retained hav-

ing a book value of \$160,000. A gain of \$532,636 was realized on this sale.

Pre-operating costs incurred in 1971 related to preparation for flight operations were expensed in that year.

6. FEDERAL INCOME TAX

At December 31, 1972, the Company has a net operating loss of approximately \$4,155,000 which may be availed of in future periods as an offset to taxable income. In addition, unused investment tax credits aggregate approximately \$485,000.

7. CONTINGENCIES

The Company has operated at a loss since it commenced operations, and while it does not anticipate losses in future years, recovery of the carrying value of its assets is dependent upon the ability of the Company to achieve profitable operations.

The Company is presently engaged in litigation to preserve its right to continue scheduled intrastate air service into and out of Love Field, Dallas, Texas after the scheduled opening of the Regional Airport in late 1973. The extent of the effect of an unfavorable decision in this litigation on the Company's future financial position and operations is not predictable at this time.

Auditor's Report

February 10, 1973

The Board of Directors and
Stockholders
Southwest Airlines Co.

We have examined the accompanying balance sheet of Southwest Airlines Co. at December 31, 1972 and the related statements of operations and deficit and changes in financial position for the year then ended. 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. We have previously made a similar examination of the financial statements for the prior period.

In our opinion, subject to the outcome of the matter described in the first paragraph of Note 7, the statements mentioned above present fairly the financial position of Southwest Airlines Co. at December 31, 1972 and 1971, the results of its operations for the year ended December 31, 1972 and the period June 18, 1971 to December 31, 1971 and the changes in its financial position for the years ended December 31, 1972 and 1971, in conformity with generally accepted accounting principles applied consistently during the period.



Arthur Young & Company
4800 One Shell Plaza
Houston, Texas 77002

Directors

Sidney A. Adger
Houston, Texas
Todd Alexander
New York, New York
A. A. Bradford
Midland, Texas
Herbert D. Kelleher
San Antonio, Texas
Rollin W. King
Dallas, Texas
M. Lamar Muse
Dallas, Texas
John Peace
San Antonio, Texas

Officers

M. Lamar Muse
President & Treasurer
Rollin W. King
Executive Vice President-Operations
Jess R. Coker
Vice President-Marketing
William W. Franklin
Vice President-Ground Operations
Donald G. Ogden
Vice President-Flight Operations
John A. Vidal
Vice President-Maintenance & Engineering
Fred A. Rigby, Jr.
Comptroller
Herbert D. Kelleher
Secretary & General Counsel
Carole Ann Brown
Assistant Secretary

The Annual Meeting of Shareholders of Southwest Airlines Co. will be held at 10:00 a.m. on Tuesday, April 24, 1973 in the Auditorium of the Mercantile National Bank located on its fourth floor at 1704 Main Street, Dallas, Texas.

Page opposite —

Left to right, front row: Sales representatives, Station operations, Reservations, Flight crew, Dispatch.

back row: Line mechanic, Provisioning, Hanger mechanic, Accounting, Secretarial, Station management, Customer service.

Clockwise from left: Coker, Vidal, Rigby, Muse, King, Franklin, Ogden, Brown







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