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MERCURY AIR GROUP INC
Form 10-K
September 28, 2001

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SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-K

(Mark One)

Annual report pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934

For the Fiscal Year ended June 30, 2001

Transition report pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934

For the transition period from _____ to _____

Commission file number: 1-7134

MERCURY AIR GROUP, INC.

(Exact Name of Registrant as Specified in Its Charter)

DELAWARE

(State or Other Jurisdiction of
Incorporation or Organization)

95-4836590

(I.R.S. Employer Identification Number)

5456 McConnell Avenue, Los Angeles, California 90066

(Address of Principal Executive Offices) (Zip Code)

Registrant's Telephone Number, Including Area Code: (310) 827-2737

Securities Registered Pursuant to Section 12(b) of the Act:

| Title of Each Class ----- | Name of Each Exchange on Which Registered ----- |
|--------------------------------|---|
| Common Stock - Par Value \$.01 | American Stock Exchange Pacific Stock Exchange |

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No.

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. Yes No .

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As of September 26, 2001, 6,576,680 shares of the Registrant's Common Stock were outstanding. Of these shares, 2,058,113 shares were held by persons who may be deemed to be affiliates. The 4,518,567 shares held by non-affiliates as of September 26, 2001 had an aggregate market value (based on the closing price of these shares on the American Stock Exchange of \$4.50 a share) of \$20,335,552. As of September 26, 2001, there were no non-voting shares of common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement which is to be distributed in connection with the Annual Meeting of Shareholders to be held in November 2001 are incorporated by reference into Part III of this Form 10-K.

(The Exhibit Index May Be Found at Page 34)

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PART I

ITEM 1. BUSINESS

Mercury Air Group, Inc., a Delaware Corporation, was organized in 1956 and provides a broad range of services to the aviation industry through four principal operating units: fuel sales, cargo operations, fixed base operations and U.S. government contract services. Fuel sales include the sale of fuel and delivery of fuel primarily to domestic and international commercial airlines, business aviation and air freight airlines. Cargo operations consist of cargo handling, space logistics operations and general cargo sales agent services. Fixed base operations ("FBOs") include fuel sales, into-plane services, ground support services, aircraft hangar and tie-down facilities and maintenance at certain locations for commercial, private, general aviation and military aircraft. Government contract services consist of aircraft refueling and fuel storage operations, base operating support (BOS) services, air terminal and ground handling services and weather observation and forecasting services performed principally for agencies of the United States government. Additionally, the Company had a fifth operating unit, RPA Airline Automation Services, Inc. ("RPA") which was sold on July 3, 2001 and is shown as a discontinued operation. As a result, RPA's current and historical operating results have been reclassified as a discontinued operation. As used in this Annual Report, the term "Company" or "Mercury" refers to Mercury Air Group, Inc. and, unless the context otherwise requires, its subsidiaries. The Company's principal executive offices are located at 5456 McConnell Avenue, Los Angeles, California 90066 and its telephone number is (310) 827-2737.

NARRATIVE DESCRIPTION OF THE BUSINESS

The events of September 11, 2001 have had a significant impact on the aviation industry and, as a result, have impacted the Company's operations as well. In the first few days following September 11, revenue from the Company's fuel sales, cargo and FBO operations were negligible. Since that time, the Company's operations have begun to return to normal. In view of the uncertainty of the ultimate impact upon the aviation industry, the long-term impact to the Company's operations cannot be determined at this time.

On March 7, 2001, the Company announced its plan to create an independent publicly-traded company, MercFuel, Inc. MercFuel, Inc. was organized in Delaware on October 27, 2000 as a wholly owned subsidiary of the Company. On

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January 1, 2001, the Company transferred to MercFuel, Inc. the assets and liabilities of its Fuel Sales division. On April 30, 2001, MercFuel, Inc. agreed to sell 239,942 shares of common stock in a private placement at a per share price of \$4.35, the net proceeds of which are \$860,000. The sale will be consummated at such time as the Company's lenders consent to that offering. On May 15, 2001, the Company contributed \$4.0 million of equity to MercFuel, Inc. in the form of cancellation of intercompany debt payable to the Company. On May 16, 2001, MercFuel filed a registration statement related to the proposed sale of 1,200,000 shares of common stock (along with an additional 180,000 shares to cover over-allotments and an option issued to the underwriter to purchase 120,000 shares, exercisable one year after the effective date of the offering at a price equal to 140% of the initial public offering price). There can be no assurance that the Company will be able to complete the initial public offering, however, if the offering is completed, the Company will own at least 80.1% of MercFuel's common stock. The Company currently intends, subject to satisfactory resolution of certain conditions, to distribute (the "Distribution") all of the shares of MercFuel common stock that the Company owns to the Company's stockholders no earlier than six months after MercFuel's initial public offering. The Distribution is subject to consent by the Company's subordinated debt holder.

FUEL SALES

The Fuel Sales division facilitates the management and distribution of aviation fuel for Mercury's airline customers which the major suppliers typically do not service. In this way, Mercury serves as a reseller from major oil companies to air carriers, affording oil companies access to these carriers without their assumption of the credit risk for these fuel purchases. Mercury competes based on quality of its service and by offering a combination of favorable pricing and credit terms, and a real time analysis of the availability, quantity and price of fuel in airports and terminals worldwide. As a result of higher volume and higher fuel prices, Mercury's revenue from fuel sales and services as a percentage of revenue increased to 66.6% of total Company revenue in fiscal 2001 from 60.7% in fiscal 2000.

Mercury believes that many of the major oil companies have limited infrastructure to support small to medium sized and emerging carriers. With over 22 years of experience in the jet fuel reselling industry, Mercury has established significant contracts with smaller and medium sized commercial carriers and business fleet managers. Mercury's resale service provides an established distribution point for oil company sales efforts worldwide and offers them access to markets which they do not directly serve. Additionally, Mercury assumes the administrative cost which would otherwise be borne by fuel suppliers and Mercury typically assumes the credit risks for fuel sales. Mercury believes its experience in the jet fuel reselling industry allows it to assess those risks in a more efficient manner. In addition, major oil companies typically do not wish to bear these credit risks.

In many cases, small to medium sized commercial carriers and business fleet managers are required to pay higher spot retail prices for fuel at the terminals they service. Mercury provides 24-hour single source coordinated fuel supply and delivery on a national and international basis. Mercury has a network of over 400 third party locations nationally and 1,000 locations internationally through which customers can purchase fuel. As a result, Mercury is able to provide its customers with consistent fuel costs from terminal to terminal which reduces arbitrary and opportunistic pricing characteristics associated with spot fuel sales. Further, Mercury believes its scale of operations and the fact that

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large oil companies are willing to extend to Mercury credit that they will not extend to smaller airlines allows the purchase of fuel on more favorable price and credit terms than would be available to most of Mercury's customers on an individual basis.

Mercury has automated its Internet process to provide online pricing, fuel location and ordering information and Mercury intends to upgrade this system to include online invoicing and ordering capability. This operation offers Mercury's customers the ability to streamline the fuel purchase process and reduce internal costs dedicated to fuel logistics by providing a single source through which fuel sales can be made and automatically released to the business jet customer.

Mercury has no long-term written agreements or other understandings with any of its Fuel Sales customers, other than National Airlines, Inc. (National Airlines filed for bankruptcy protection on December 6, 2000 and the Company continues to sell fuel to National Airlines on a secured basis, under the auspices of the bankruptcy court), that relate to future purchases, so purchases by Mercury's customers can be reduced or terminated upon short notice at any time.

Mercury believes its success in attracting customers has been due, in part, to its willingness to extend credit on an unsecured basis to customers, which would otherwise be required to prepay or post letters of credit with their suppliers of fuel and related services. Mercury recognizes that active management of its credit risk is essential to the Company's success. The Company's sales executives and their staff meet regularly to evaluate credit exposure, in the aggregate and by individual credit. Mercury's credit committees are responsible for approving credit limits above certain amounts, and setting and maintaining credit standards and ensuring the overall quality of the credit portfolio. Mercury also maintains credit risk insurance for certain qualified accounts.

Mercury purchases fuel at current market prices from a number of major oil companies and certain independent and state owned oil companies based on the expected requirements of its customers. From time-to-time, Mercury will commit to purchase a fixed volume of fuel, at a fixed price, over a fixed period of time, at agreed upon locations based on selected customers' corresponding purchase commitments. Mercury's terms of payment generally range from 10 to 30 days for most of its fuel purchases, except for bulk purchases, which generally are payable in shorter time periods. Mercury has agreements with certain suppliers under which Mercury purchases a minimum amount of fuel each month at prices which approximate current market prices. Mercury makes occasional spot purchases of fuel to take advantage of market differentials. In order to meet customer supply requirements, Mercury carries limited inventories at numerous locations. Due to the nature of Mercury's business, the volume of Mercury's aviation fuel inventories will fluctuate.

Outside of the United States, Mercury does not maintain fuel inventory, rather, Mercury arranges to have fuel delivered directly into the customer's aircraft on an into-plane basis. In the United States, sales are either made on an into-plane basis directly into a customer's aircraft with fuel provided by the Company's suppliers or fuel is delivered from the Company's inventory. Inventory is held at multiple locations in the United States and inventory levels are kept at an operating minimum. Mercury has arrangements with its suppliers and other third parties for the storage and delivery of fuel and related aviation services.

Mercury purchases its fuel from suppliers worldwide. For the year ended June 30, 2001, approximately 28% of its jet fuel purchases were made from British Petroleum and approximately 12% were made each from Tosco and ARCO. ARCO is affiliated with British Petroleum. Mercury's cost of fuel is generally tied

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to market-based formulas. Mercury is currently extended unsecured credit for its fuel purchases. If Mercury's relationship with any of these key suppliers terminates, Mercury may not be able to obtain a sufficient quantity of fuel on favorable terms. Mercury may experience difficulty and delays in obtaining fuel from alternative sources of supply. Furthermore, financial or other difficulties faced by these suppliers, fuel shortages or significant changes in demand for fuel could limit the availability of fuel.

Mercury's fuel supply contracts may generally be canceled by either party with no further obligations. In some cases, Mercury has monthly purchase requirements which are established based on historical volumes of fuel purchased by Mercury. Such fuel purchase history may result in the seller agreeing to provide a monthly allocation to Mercury such that the seller agrees to dedicate a portion of its available fuel for Mercury's requirements. Mercury benefits from such an allocation because, during periods of short fuel supply, reductions in supply are generally made first to those buyers who have not been given any allocation. To maintain dedicated

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allocations of fuel, Mercury usually purchases fuel at levels approximating the allocated amount. However, Mercury is not obligated to purchase any fuel under such an allocation. Currently, the monthly allocations from Mercury's fuel suppliers represent only a small portion of Mercury's monthly supply requirements.

In fiscal 2001, average per gallon fuel cost rose 21% compared to average fuel cost in 2000. In fiscal 2000, average per gallon fuel cost rose 58% compared to average fuel cost in fiscal 1999. Although Mercury believes that there are currently adequate aviation fuel supplies, events outside the Company's control have in the past resulted and could in the future result in spot shortages or further rapid increases in fuel costs. Although Mercury has generally been able to pass through rising fuel costs to its customers, extended periods of high fuel costs could adversely affect its ability to purchase fuel in sufficient quantities because of credit limits placed on the Company by its fuel suppliers.

FIXED BASE OPERATIONS

Mercury currently provides FBO services at 19 airports throughout the United States. For the year ended June 30, 2001, FBO operations comprised 20.8 % of the total Company revenue. At each FBO, Mercury maintains administrative offices; conducts retail fuel sales and refueling operations which service principally corporate and private aircraft ("general aviation") and to some extent commercial airlines; acts as a landlord for office, aircraft tie-down and hangar space tenants; and provides aircraft maintenance at a few select locations. The FBOs operate refueling vehicles and maintain fuel storage tanks as required to support into-plane and fuel sales activities. The FBO facilities and the property on which operations are conducted are leased from the respective airport authorities. Fifteen of Mercury's FBOs are currently directly owned by the Company, the remaining FBOs are owned by Mercury Air Centers, Inc. ("Air Centers") which is a wholly owned subsidiary of the Company.

The Company's FBO operations have grown principally as a result of the acquisition of additional operations or locations as well as facility enhancements at existing locations. In fiscal 2001, the Company acquired the assets of an FBO located in Birmingham, Alabama at a cost of approximately \$6.6 million, which the Company funded under its existing senior credit facilities. Also, in fiscal 2001, the Company acquired additional assets related to the

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Tulsa, Oklahoma FBO for a cash consideration of \$3.8 million which the Company funded under its existing senior credit facilities. In fiscal 2000, the Company acquired assets of several FBO's located in Fort Wayne, Indiana; Tulsa, Oklahoma; and at Charleston International Airport and John's Island Executive Airport in South Carolina. In fiscal 1999, the Company acquired certain assets of an FBO located in Jackson, Mississippi. In fiscal 1998, the Company entered into a new lease for its Burbank FBO pursuant to which it constructed 3 new hangars and built an executive terminal and refurbished certain existing facilities. Also in fiscal 1998, the Company acquired certain assets of an FBO located in Nashville, Tennessee. In fiscal 1997, the Company entered into an agreement to operate an FBO, which opened in November 1998, in Charleston, South Carolina. Also in fiscal 1997, the Company acquired certain assets of six FBO's from Raytheon Aircraft Services, Inc. and acquired an FBO in Fresno, California. Management intends to continue pursuing FBO acquisitions and facility enhancements to the extent permitted under its credit facilities but no assurance can be given that acquisition or enhancement opportunities will be available at prices which will maintain existing levels of profitability or be approved under its credit facilities.

CARGO OPERATIONS

The Company's cargo operations are conducted through its wholly-owned subsidiary, Mercury Air Cargo, Inc. ("MAC"), which provides the following services: cargo handling, space logistics and general cargo sales agent services. Cargo operations comprised 6.6% of total Company revenue for the year ended June 30, 2001. Each of MAC's services facilitates the movement of domestic and international cargo. Accordingly, results for MAC's operations depend, in part, on certain economic factors which affect the volume of cargo transported throughout the world.

Cargo Handling

MAC provides domestic and international air cargo handling, air mail handling and bonded warehousing. MAC is one of only 4 non-airline providers of contractual cargo containerization and palletization for domestic and international airlines and cargo airlines at Los Angeles International Airport (LAX). MAC specializes in consolidating smaller parcels into air cargo pallets and breaking down shipping containers for sea-to-air and air-to-air transfers.

MAC handles cargo at LAX, William B. Hartsfield International Airport (ATL), Dorval International Airport (YUL), Mirabel International Airport (YMX) and Lester B. Pearson International Airport (YYZ). In March 1998, MAC expanded its cargo handling operations by acquiring the assets of Intermodal Services, Inc. located in Atlanta, Georgia. In April 1998, MAC completed construction and commenced operation of a 174,000 square foot warehouse at LAX under a five year lease which was subsequently

extended to June 2006. MAC is currently the largest independent cargo handling company at LAX. In February 2001, MAG entered into a new ten year lease for a 104,646 square foot warehouse and operations area at Atlanta Hartsfield Airport. At the same time MAC closed down its former warehouse in Atlanta. MAC competes in the cargo handling business based on quality and price of service. Long term growth in MAC's cargo handling operations can only be realized by maintaining existing locations and obtaining new locations or by expanding current facilities.

Space Logistics

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MAC brokers cargo space on transcontinental flights within the United States and on international flights to Europe, Asia, the Middle East, Australia, Mexico and Central and South America. Space logistics involves contracting for bulk cargo space on airlines and selling that space to customers with shipping needs. MAC has established a network of shipping agents who assist in obtaining cargo for shipment on space purchased from airlines, and who facilitate the delivery and collection of freight charges for cargo shipped by MAC.

On June 1, 2001, MAC entered into a one year renewal of its contract to purchase all of South African Airlines ("SAA") cargo capacity on its passenger flights from the United States and Canada to South Africa. MAC's one year commitment for these routes is approximately \$6.2 million.

Unlike an air cargo airline which operates its own aircraft, MAC's space logistics business purchases committed cargo space on scheduled airline flights or supplemental flights at negotiated rates. MAC is thereby able to profit from the sale of cargo transportation space worldwide without the fixed overhead expense of operating aircraft. In some instances, MAC has entered into fixed minimum commitments for cargo space in order to obtain exclusive or preferred rights to broker desirable cargo space profitably and may do so in the future. With its volume of cargo space purchases and its ability to negotiate among airlines, MAC adds value for its customers and is able to attract business by offering favorable pricing to the domestic and international freight forwarding community. MAC records revenue as the difference between the cost of the space and the amount at which the space is resold.

General Sales Agent Services

MAC also serves as general cargo sales agent directly and through its subsidiaries, Hermes Aviation, Inc., Hermes Aviacion de Mexico, S.A. de C.V. and Aero Freightways, Inc. of Canada for airlines in the Far East, Canada, Mexico, Central and South America and in the United States. In this capacity, MAC sells the transportation of cargo on client airlines' flights, using the client airlines' own air waybills. MAC earns commissions from the airlines for selling their cargo space. As with its space logistics operations, the growth potential for MAC's general cargo sales agent business is not limited by requirements for physical facilities or by requirements for additional capital investments.

Air Mercury

Using its part 135, cargo airline certificate, Air Mercury is able to enter into interline agreements with other airlines around the world. Using the Air Mercury airway bill as the cargo transportation document and the other airline's cargo capacity, MAC is able to provide a service for both freight forwarders and airlines. Effectively, Air Mercury provides a secondary brand to airlines which prefer not to utilize their own brand for discounted freight.

GOVERNMENT CONTRACT SERVICES

Mercury conducts its government contract services through its wholly owned subsidiary, Maytag Aircraft Corporation ("Maytag"), which is headquartered in Colorado Springs, Colorado. Maytag provides aircraft refueling, air terminal services, base operating support services, and weather observation and forecasting services in 17 countries on four continents.

Aircraft Refueling

Maytag provides aircraft refueling and related services at 15 United States military bases, including fourteen in the United States and one in Greece. Maytag's refueling contracts generally have a term of four years, with expiration dates ranging from February 2002 to January 2005. Refueling contracts

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provide a firm-fixed price for specified services. Under the terms of its refueling contracts, Maytag supplies all necessary personnel and equipment to operate government-owned fuel storage facilities and provides 24-hour

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refueling services for a variety of aircraft for the military. All fuel handled in these operations is government owned. In connection with its government contract refueling business, Maytag owns and operates a fleet of refueling trucks and other support vehicles.

Air Terminal Services

Maytag provides air terminal and ground handling services to the United States Government at 19 locations under seven contracts. Six contracts cover three U.S. military bases in Alaska, Japan, and Korea, and three international airports in Japan, Korea, and Kuwait. Maytag also has one contract servicing international airports in Latin America. Air terminal services contracts are generally for a base period of up to one year, with government options for multiple one-year extension periods. The expiration date for all of Maytag's air terminal contracts is presently September 2002. Air terminal contracts provide a firm-fixed price for specified services. Discretionary performance-based awards are also available at the five Pacific Rim locations. Air terminal and ground handling services include the loading and unloading of passengers and cargo, transient alert, and flight planning services

Base Operating Support Services

Maytag provides base operating support (BOS) services at Niagara Falls, NY, Westover, MA, Youngstown, OH, Willow Grove, PA Air Reserve Facilities and Patrick Air Force Base on a subcontracted basis. Under the terms of the subcontracts, Maytag provides, at a firm-fixed price, multi-function services, including fuel management, traffic management, airfield management, air terminal operations, vehicle operations and maintenance services, and meteorological services. Contract expirations range from September 2001 through March 2002, with two to four pre-priced one-year options.

Weather Observation and Forecasting Services

Maytag provides weather observation and/or weather forecasting services at 17 locations within the United States pursuant to 10 contracts with the United States Government and certain local governmental agencies. This includes one weather observation and forecasting contract and 9 weather observation contracts. The Weather Data contracts provide firm fixed prices for specified services and are generally for a base period of one year, with multiple one-year options at the government's election. Some of Weather Data's existing contracts were extended for a one year period ending September 30, 2001, with remaining extension options ranging up to two periods on a majority of the contracts.

All of Maytag's government contracts are subject to competitive bidding. Refueling, air terminal, and weather forecasting contracts are generally awarded to the offeror with the proposal that represents the "best value" to the government. In a "best value" competition, the proposals are evaluated on the basis of price, past performance history of the offeror, and the merit of the technical proposal, creating a more subjective process. Weather observation contracts are generally awarded to the offeror with the lowest priced technically acceptable proposal. A significant contract, Yokota, Japan, which provided revenue of \$5.1 million or 17.6% of Maytag's total revenues during fiscal year 2001, terminated in September 2001 and was not renewed.

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Maytag's contracts are all subject to termination at the discretion of the United States Government, in whole or in part. Termination of a contract may occur if the United States Government determines that it is in its best interest to discontinue the contract, in which case closure costs will be paid to Maytag. Termination may also occur if Maytag defaults under a contract. Maytag has never experienced any such default termination.

RPA

On July 3, 2001, the Company sold substantially all of the assets of RPA Airline Automation Services (now Jupiter Airlines Automation Services, Inc.) for cash consideration of \$3.6 million. The Company realized a loss of approximately \$0.5 million on the sale of discontinued operations.

MAJOR CUSTOMERS

During fiscal 2001, EVA Airways Corporation accounted for approximately 12% of cargo operations revenue, National Airlines, Inc. represented approximately 22% of fuel sales revenue and approximately 14% of consolidated revenue and AirTran Airways, Inc. represented approximately 20% of fuel sales revenue and approximately 14% of consolidated revenue. During fiscal 2001, government contract services consisted entirely of revenues from agencies of the United States Government. No other customers accounted for over 10% of Mercury's consolidated revenue or 10% of revenues for any of the four reporting units.

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The Company does business with a number of foreign airlines, principally in the sale of aviation fuels. For the most part, such sales are made within the United States and utilize the same assets and generally the same personnel as are utilized in the Company's domestic business. Revenues related to these foreign airlines amounted to approximately 18%, 25% and 29% of consolidated revenues for the years ended June 30, 2001, 2000 and 1999, respectively.

In May 1999, Mercury entered into a fuel management contract with National Airlines, Inc., pursuant to which Mercury began selling fuel to National Airlines, Inc. and managing their fuel requirement at all National Airlines, Inc. locations. On December 6, 2000, National Airlines filed for bankruptcy protection. Mercury continues to sell fuel to National on a secured basis, under the auspices of the bankruptcy court.

SEASONAL NATURE OF BUSINESS

Mercury's commercial fuel sales, FBOs and aircraft support operations are seasonal in nature, being relatively stronger during the months of April through December in its fueling operations and FBOs than during the winter months due in part to weather conditions, and increased during summer months due in part to additional commercial and charter flights. MAC's cargo business is lower during the months of January and February and increases March through December. The cargo business is affected by the patterns of international trade. Operations at military facilities are not seasonal.

POTENTIAL LIABILITY AND INSURANCE

Mercury's business activities subject it to risk of significant potential liability under federal and state statutes, common law and contractual indemnification agreements. Mercury reviews the adequacy of its insurance on an on-going basis. Mercury believes it follows generally accepted standards for its

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lines of business with respect to the purchase of business insurance and risk management practices. The Company purchases airport liability and general and auto liability in amounts which the Company believes are adequate for the risks of its business.

COMPETITION

The Fuel Sales division of Mercury competes with approximately five independent fuel suppliers, of which the largest is World Fuel Services Corporation. Additionally, the division competes with other aircraft support companies which maintain their own sources of aviation fuel. Many of the divisions competitors have greater financial, technical and marketing resources than Mercury. In addition, certain airlines provide cargo and fueling services comparable to those furnished by Mercury. At LAX Mercury competes with, in addition to the airlines, 3 fuel delivery providers and with 3 non-airline entities with respect to air cargo handling business. Generally, FBOs have a minimum of one competitor at each airport as well as national multi-location chains. Mercury has many principal competitors with respect to government contracting services including certain small disadvantaged businesses which receive a ten percent cost advantage with respect to certain bids and set asides of certain contracts. Recently the FBO market has seen the emergence of increased competition among several national FBO chains owned by major corporations whose total sales and financial resources exceed those of Mercury. Substantially all of Mercury's services are subject to competitive bidding. Mercury competes on the basis of price, prior relationship to the customer and credit terms.

ENVIRONMENTAL MATTERS

Mercury must continuously comply with federal, state and local environmental statutes and regulations associated with its fuel storage tanks. These requirements include, among other things, tank and pipe testing for integrity and soil sampling for evidence of leaking and remediation of detected leaks and spills. Other than the \$3.4 million spent during the 1999 fiscal year to comply with certain federal mandates regarding below ground fuel tanks, there have been no material capital expenditures nor has there been a material negative impact on Mercury's earnings or competitive position in performing such compliance and related remediation work. In late 1998, Mercury, and many other companies operating on Southern California airports received notice of potential violations of California Environmental Protection Agency - Air Resources Board regulations. This notice alleged that such companies had violated the act by fueling airport service vehicles with Jet A fuel. Mercury immediately brought all of its operations into full compliance with all applicable regulations and has entered into a settlement agreement with the state of California. In addition, it has undertaken a review of federal and state regulations to insure future compliance. The Company has agreed to provide certain environmental remediation on property formerly leased by the Company in Anaheim, California. The Company terminated operations on this leased property in fiscal 1987 at which time a closure letter was in effect. The Company has installed an approved remediation system at a cost of approximately \$78,000 and expects to incur maintenance cost for a period of between 6 and 24 months of \$4,500 per month.

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Mercury knows of no other basis for any notice of violation or cease and abatement proceeding by any governmental agency as a result of failure to comply with applicable environmental laws and regulations.

EMPLOYEES

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As of August 31, 2001, Mercury employed 1,736 full-time and 223 part-time persons in its following operating units: fuel sales, 35 full-time and 1 part-time persons; corporate, 47 full-time persons; cargo operations, 555 full-time persons; FBOs, 734 full-time and 17 part-time persons; and government contract services, 365 full-time and 205 part-time persons. Maytag has collective bargaining agreements which affect approximately 132 employees in its weather and base support operations. Management believes that, in general, wages, hours, fringe benefits and other conditions of employment offered throughout Mercury's operations are at least equivalent to those found elsewhere in its industry and that its general relationship with its employees is satisfactory

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ITEM 2. PROPERTIES

Listed below are the significant properties leased or owned by Mercury as of June 30, 2001:

| LOCATION | LEASED OR OWNED | ANNUAL RENTAL | EXPIRATION OF LEASE | ACTIVITY AT FACILITY |
|---|-----------------|---------------|---------------------|--|
| CORPORATE HEADQUARTERS 5456 McConnell Los Angeles, CA (1) | Owned | N/A | N/A | Landlord, executive and support personnel office |
| MAYTAG OPERATIONS 6145 Lehman Drive, Suite 300 Colorado Springs, CO (2) | Owned | N/A | N/A | Landlord, executive and support personnel office |
| FLORIDA BUILDINGS 129 S.W. 36th Court Miami, FL (4) | Owned | N/A | N/A | Land |
| 101 S.W. 36th Court Miami, FL (4) | Owned | N/A | N/A | Land |
| 119 S.W. 36th Court Miami, FL (4) | Owned | N/A | N/A | Office Building |
| 115 S.W. 36th Court Miami, FL (4) | Owned | N/A | N/A | Office Building |
| 2000 N.W. 89th PL Miami, FL (3) | Owned | N/A | N/A | Office Building |
| HARTSFIELD ATLANTA INT'L AIRPORT Cargo Building "A" South Cargo Area | Leased | \$924,061 | February 2011 | Cargo handling warehouse with |

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offices

| | | | | |
|--|--------|-------------|----------------|--|
| LOS ANGELES INT'L AIRPORT 6851 W. Imperial Highway, Los Angeles, CA (6) | Leased | \$754,000 | Month-to-month | Cargo hangar, w offices and executive offic rented to custo |
| 6040 Avion Drive Los Angeles, CA | Leased | \$2,232,000 | June 2006 | Cargo handling warehouse with offices |
| LESTER B. PEARSON INT'L AIRPORT Building D Toronto, AMF Ontario | Leased | \$378,000 | Month-to-month | Cargo handling warehouse with offices |
| Concession 6 East Hurontario St. (4) | Leased | \$121,800 | November 2010 | Cargo handling warehouse with offices |

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| LOCATION | LEASED OR OWNED | ANNUAL RENTAL | EXPIRATION OF LEASE | ACTIVITY AT FACILITY |
|--|-----------------|---------------|---------------------|--|
| DORVAL INT'L AIRPORT 800 Stuart Graham Blvd. South Dorval, Quebec (5) | Leased | \$489,000 | November 2007 | Cargo handling warehouse with offices |
| MIRABEL INT'L AIRPORT 12005, Rue Cargo A-3, Suite 102 Mirabel, Quebec | Leased | \$83,000 | November 2005 | Cargo handling warehouse with offices |
| LOS ANGELES INT'L AIRPORT 7000 World Way West Los Angeles, CA | Leased | \$375,600 | Month-to-month | Service and refueling of pr aircraft |
| ONTARIO INT'L AIRPORT 2161 East Avion Ontario, CA | Leased | \$225,000 | April 2008 | Landlord, servi and refueling o commercial and |

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| | | | | |
|--|--------|-------------|----------------|--|
| 1150 S. Vineyard Ontario, CA | Leased | \$144,000 | November 2001 | private aircraft Landlord, service and refueling of commercial and private aircraft |
| BAKERSFIELD AIRPORT 1550 Skyway Drive Bakersfield, CA (5) | Leased | \$138,000 | May 2020 | Landlord, service and refueling of commercial and private aircraft |
| BURBANK-GLENDALE-PASADENA AIRPORT 4301/4405/4407/4409/4411 /4531 Empire Avenue 10660/10670/10700/10750/ 10760/10800/10820 Sherman Way, Burbank, CA | Leased | \$1,626,000 | April 2025 | Landlord, service and refueling of commercial and private aircraft |
| 6920 Vineland Ave. No. Hollywood, CA | Leased | \$164,000 | Month to month | Landlord, service and refueling of commercial and private aircraft |
| CHARLESTON INTERNATIONAL AIRPORT 6060 S Aviation Wy N. Charleston, SC | Leased | \$170,000 | August 2007 | Terminal, office and hangars |
| 6070 Perimeter. N. Charleston, SC | Leased | \$21,000 | Month-to-month | Building and hangar space |
| Johns Island Airport 2700 Fort Trenholm Johns Island, SC | Leased | \$26,130 | May 2004 | Terminal, office and hanger space |

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| LOCATION | LEASED OR OWNED | ANNUAL RENTAL | EXPIRATION OF LEASE | ACTIVITY AT FACILITY |
|--|-----------------|---------------|---------------------|---|
| SANTA BARBARA MUNICIPAL AIRPORT 404 Moffet Road Goleta, CA | Leased | \$2,700 | Month-to-month | Landlord, service maintenance, and refueling of |

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| | | | | |
|--|-----------------------------|-----------|----------------|--|
| | | | | commercial and private aircraft |
| 404 Moffet Road Goleta, CA (Building 124 &126) | Leased | \$56,000 | Month-to-month | Building space |
| 204 Moffett Place Goleta, CA Building 121 | Leased | \$30,000 | Month-to-month | Building space parking spaces |
| 302 Moffet Place Goleta, CA Building 122 | Leased | \$41,500 | Month-to-month | Building space |
| FRESNO YOSEMITE INT'L AIRPORT 5045 E. Anderson Avenue Fresno, CA(5) | Leased | \$74,000 | April 2020 | Landlord, service and refueling of commercial and private aircraft |
| 5045 E. Anderson Avenue Fresno, CA(5) | Leased | \$67,000 | August 2006 | Terminal, office hangar facility |
| 5045 E. Anderson Avenue Fresno, CA(5) | Leased | \$115,000 | May 2005 | Hangar and commercial office space |
| WM. B. HARTSFIELD INT'L AIRPORT 1200 Toffie Terrace Atlanta, GA | Leased | \$107,000 | March 2002 | Landlord, service and refueling of commercial and private aircraft |
| DEKALB-PEACHTREE AIRPORT 1951 Airport Road Atlanta, GA (5) | Leased | \$220,000 | November 2006 | Landlord, service and refueling of commercial and private aircraft |
| L.G. HANSCOM FIELD AIRPORT 180 Hanscom Drive Bedford, MA (5) | Leased | \$333,000 | May 2012 | Landlord, service maintenance and refueling of commercial and private aircraft |
| RENO CANNON INT'L AIRPORT 655 So. Rock Blvd. Reno, NV | Building owned, land rented | \$22,000 | June 2017 | Landlord, service and refueling of commercial, private and military aircraft |

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| LOCATION | LEASED OR OWNED | ANNUAL RENTAL | EXPIRATION OF LEASE | ACTIVITY AT FACILITY |
|--|-----------------|---------------|---------------------|--|
| ADDISON AIRPORT 4400 Glenn Curtiss Dr. Dallas, TX (5) | Leased | \$314,000 | September 2021 | Landlord, service and refueling of commercial and private aircraft |
| 4400 Glenn Curtiss Dr. Dallas, TX (5) | Leased | \$56,000 | June 2022 | Landlord, service and refueling of commercial and private aircraft |
| 4400 Glenn Curtiss Dr. Dallas, TX (5) | Leased | \$9,000 | July 2021 | Landlord, service and refueling of commercial and private aircraft |
| 4400 Glenn Curtis Dr. Dallas, TX (5) | Leased | \$28,000 | Month-to-month | Fuel farm |
| CORPUS CHRISTI 355 Pinson Drive Corpus Christi, TX (5) | Leased | \$19,000 | October 2009 | Landlord, service and refueling of commercial and private aircraft |
| NASHVILLE INT'L AIRPORT 635 Hangar Lane Nashville, TN | Leased | \$350,000 | June 2012 | Landlord, service and refueling of commercial and private aircraft |
| JACKSON INT'L AIRPORT 110 S. Hangar Drive Jackson, MS 39208 (5) | Leased | \$112,000 | February 2006 | Landlord, service and refueling of commercial and private aircraft |
| TULSA INT'L AIRPORT 7500 E. Apache Tulsa, OK 74115 Hangar 1&2 | Leased | \$73,000 | April 2019 | Landlord, service and refueling of commercial and private aircraft |
| 7500 E. Apache Tulsa, OK 74115 Hangar 22 & 26 | Leased | \$22,000 | April 2019 | Landlord, service and refueling of commercial and private aircraft |
| 7500 E. Apache Tulsa, OK 74115 Hangar 22 & 26 | Leased | \$62,000 | June 2011 | Landlord, service and refueling of commercial and private aircraft |

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| | | | | |
|--|--------|----------|----------------|--|
| 7500 E. Apache Tulsa, OK 74115 Hangar 18 | Leased | \$11,000 | June 2007 | private aircraft Landlord, service and refueling of commercial and private aircraft |
| 7500 E. Apache Tulsa, OK 74115 Hangar 4 | Leased | \$36,000 | Month-to-month | Landlord, service and refueling of commercial and aircraft |

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| LOCATION | LEASED OR OWNED | ANNUAL RENTAL | EXPIRATION OF LEASE | ACTIVITY AT FACILITY |
|--|-----------------|---------------|---------------------|--|
| FORT WAYNE AIRPORT Fort Wayne- Allen County Airport Authority Ramp | Leased | \$21,400 | December 2003 | Aircraft parking |
| Fort Wayne-Allen County Airport Authority Hangar 37,41, 41A Building 28 | Leased | \$44,000 | December 2003 | Landlord, service and refueling of commercial and private aircraft |
| Fort Wayne-Allen County Airport Authority Hangar 40, 43 | Leased | \$68,000 | December 2003 | Landlord, service and refueling of commercial and private aircraft |
| Fort Wayne-Allen County Airport Authority Hangar 42 | Leased | \$58,500 | November 2004 | Landlord, service and refueling of commercial and private aircraft |
| Fort Wayne-Allen County Airport Authority Hangar 45 | Leased | \$40,400 | October 2016 | Landlord, service and refueling of commercial and private aircraft |
| Fort Wayne-Allen County Airport Authority Hangar D | Leased | \$8,600 | August 2002 | Landlord, service and refueling of commercial and private aircraft |
| Fort Wayne-Allen County Airport Authority T-Hangar | Leased | \$2,100 | Month-to-month | Landlord, service and refueling of commercial and private aircraft |
| Fort Wayne-Allen County Airport Authority | Leased | \$21,400 | November 2004 | Landlord, service and refueling of |

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| | | | | |
|---|--------|-----------|---------------|--|
| Parcel No. 1,2, & 3 | | | | commercial and private aircraft |
| Fort Wayne-Allen County Airport Authority | Leased | \$100 | December 2005 | Landlord, service and refueling of commercial and private aircraft |
| BIRMINGHAM AIRPORT | | | | |
| Birmingham Airport | Leased | \$155,000 | August 2021 | Landlord, service and refueling of commercial and private aircraft |

- (1) This property was purchased in April 1994 for \$1,800,000 and is subject to a first mortgage to Sanwa Bank in the sum of \$332,000 at June 30, 2001 repayable in equal monthly installments of principal of \$9,750, plus interest at 7.5% per annum, the last payment due in April 2004.
- (2) This property was purchased in May 1995 for \$515,000 and is subject to a first mortgage to U.S. Bank in the sum of \$323,000 at June 30, 2001 repayable with interest at 9% in equal monthly installments of approximately \$4,450, the last payment due May 2010.
- (3) Leased to SITA Information Networking Computing USA, Inc. until December 31, 2002.
- (4) Leased to R&M Investment Corporation under a lease dated July 2, 1999 with an option to purchase.
- (5) The leasehold interest is subject to security interest granted to Fleet National Bank f/k/a Bank Boston.
- (6) Commencing January 2000 and continuing on a month-to-month basis thereafter until not later than December 31, 2004.

At most commercial airports where Mercury operates FBOs, Mercury maintains its own fuel storage capabilities. The following table summarizes Mercury's existing fuel storage facilities.

| LOCATION ----- | APPROXIMATE CAPACITY (GALLONS) ----- |
|---------------------------|---|
| Los Angeles, California | 311,000 (UG) |
| Bakersfield, California | 98,000 (62,000 AG; 36,000 UG) |
| Burbank, California | -- (1) |
| Santa Barbara, California | -- (2) |
| Reno, Nevada | 99,000 (AG) |
| Ontario, California | 88,000 (UG) |
| Dallas, Texas | 57,000 (UG) (3) |
| Corpus Christi, Texas | 25,000 (AG) |

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| | |
|-------------------------------|-----------------|
| Atlanta, Georgia (Hartsfield) | 48,000 (AG) |
| Atlanta, Georgia (Peachtree) | 48,000 (AG) |
| Fresno, California | 73,000 (AG) |
| Bedford, Massachusetts | 30,000 (AG) |
| Nashville, Tennessee | 37,000 (AG) |
| Charleston, South Carolina | 38,000 (AG) |
| Jackson, Mississippi | 43,000 (AG) (4) |
| Tulsa, Oklahoma | 126,000 (UG) |
| Fort Wayne, Indiana | 171,000 (AG) |
| John's Island, South Carolina | 18,000 (UG) |
| Birmingham, Alabama | 145,500 (AG) |

(AG) = Above-ground fuel storage (UG) = Under-ground fuel storage

(1) Consortium fuel farm used as an alternative.

(2) Interim operations without a fuel farm, new above ground fuel farm approved and will be installed within 12 months.

(3) Facility owned by a third-party.

(4) Presently use a third party tank farm consortium, for balance of requirement.

Management believes that Mercury's property and equipment are adequate for its present business needs. Mercury fully utilizes the real properties it owns or leases for its business. Mercury's operating profits are substantially dependent on a number of its leased facilities which enjoy strategic airport locations and could be adversely affected by a failure to obtain alternative facilities or renew a lease at expiration.

ITEM 3. LEGAL PROCEEDINGS.

On March 16, 2001, the bankruptcy court approved a settlement related to preference payments received in connection with the Chapter 7 bankruptcy filing of Western Pacific Airlines, Inc ("WPAI"). The settlement consists of ten quarterly payments of \$175,000, two of which were made in the current fiscal year with the unpaid balance secured by a letter of credit. The Company has recorded a charge to bad debt expense equal to the present value of the payments, \$1.6 million. The outstanding balance at June 30, 2001 was \$1.3 million.

In November 1999, Mr. Perez, formerly the President of RPA, filed a lawsuit alleging violations of his employment contract between the Company, RPA and Mr. Perez asserting, among other things, constructive termination. During the quarter ended March 31, 2001, this suit was dismissed.

In February 2001, Mercury received notice of a complaint filed by the Chapter 7 Trustee for Tower Air, Inc. in regard to a preference action. In July 2001, the Company settled this matter for \$1.0 million. In accordance with the terms of the settlement, the Company paid \$750,000 subsequent to June 30, 2001 and will pay the balance in ten monthly installments of \$25,000 each. At June 30, 2001, the unpaid settlement balance was \$750,000 and the unpaid note balance, which is secured by a letter of credit, was \$250,000.

In April 2000, Mercury filed a collection action against AER Global

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Logistics ("AER") in the state of New York. AER filed a counterclaim for \$1.0 million alleging among other things, tortuous interference with contract. Mercury believes that this claim is without merit, and accordingly, does not believe this matter will have a significant impact on its financial position or operating results.

On April 3, 2001 Mercury received notice of an action filed by Skylink Express, Inc. in the Superior Court of Justice Ontario, Canada against Excel Cargo, Inc. and others for damages to aircraft occurring on November 30, 1999 and January 10, 2000 at Mirabel International Airport Quebec for a total amount of \$2.5 million Canadian (\$1.7 million U.S.) plus interest and fees. Mercury does not believe the outcome of this claim will have a significant impact on its financial position or operating results.

The Company is also a defendant in certain litigation arising in the normal course of business. In the opinion of management, the ultimate resolution of such litigation will not have a significant effect on the financial statements.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.

None.

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PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS.

Mercury's Common Stock is listed and traded on the AMEX under the Symbol "MAX". The table below sets forth, for the quarterly periods indicated, the high and low closing sale prices per share of Common Stock

| | HIGH | LOW |
|--|---------|---------|
| | ----- | ----- |
| FISCAL 2001: | | |
| Quarter ended September 30, 2000 | \$ 7.19 | \$ 6.00 |
| Quarter ended December 31, 2000 | 6.50 | 4.56 |
| Quarter ended March 31, 2001 | 6.95 | 4.75 |
| Quarter ended June 30, 2001 | 7.39 | 5.37 |
| FISCAL 2000: | | |
| Quarter ended September 30, 1999 | \$ 7.63 | \$ 6.13 |
| Quarter ended December 31, 1999 | 8.25 | 5.63 |
| Quarter ended March 31, 2000 | 9.50 | 6.13 |
| Quarter ended June 30, 2000 | 7.75 | 4.63 |

As of September 18, 2001 there were approximately 333 holders of record.

ITEM 6. SELECTED FINANCIAL DATA

The following selected consolidated financial data for each of the five years ended June 30 have been derived from the audited consolidated financial statements of Mercury. The information set forth below should be read in conjunction with the consolidated financial statements and notes thereto and

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"Management's Discussion and Analysis of Financial Condition and Results of Operations" included elsewhere in this Form 10-K.

| | YEAR ENDED JUNE 30, | | |
|--|---|------------|------------|
| | (DOLLARS IN THOUSANDS, EXCEPT PER SHARE DATA) | | |
| | 2001 | 2000 | 1999 |
| | ----- | ----- | ----- |
| Operating Data | | | |
| Sales and Revenues | \$ 478,446 | \$ 334,333 | \$ 218,272 |
| Costs and Expenses | 443,504 | 299,919 | 187,052 |
| | ----- | ----- | ----- |
| Gross Margin | 34,942 | 34,414 | 31,220 |
| Selling, General and Administrative Expenses | 7,929 | 7,223 | 7,118 |
| Provision for Bad Debts | 3,425 | 5,408 | 1,721 |
| Depreciation and Amortization | 10,008 | 9,162 | 8,297 |
| Loss Resulting from Bankruptcy of a Customer | 300 | -- | -- |
| Interest Expense | 7,184 | 6,293 | 4,379 |
| Other (Income) Expense, net | (48) | (133) | (178) |
| | ----- | ----- | ----- |
| Income before Income Taxes | 6,144 | 6,461 | 9,883 |
| Provision for Income Taxes | 2,397 | 2,520 | 3,854 |
| | ----- | ----- | ----- |
| Income from continuing operations | 3,747 | 3,941 | 6,029 |
| (Loss) income from discontinued operations | (858) | (933) | 393 |
| Loss on sale of discontinued operations | (477) | -- | -- |
| Extraordinary Item | -- | (979) | (483) |
| | ----- | ----- | ----- |
| Net Income | \$ 2,412 | \$ 2,029 | \$ 5,939 |
| | ----- | ----- | ----- |
| Net Income Per Share: | | | |
| Basic: | | | |
| From continuing operations | \$ 0.57 | \$ 0.60 | \$ 0.90 |
| (Loss) income from discontinued operations | (0.13) | (0.14) | 0.06 |
| Loss on sale of discontinued operations | (0.07) | -- | -- |
| Extraordinary item | -- | (0.15) | (0.07) |
| | ----- | ----- | ----- |
| Net income | \$ 0.37 | \$ 0.31 | \$ 0.89 |
| | ----- | ----- | ----- |
| Diluted: | | | |
| From continuing operations | \$ 0.56 | \$ 0.55 | \$ 0.69 |
| (Loss) income from discontinued operations | (0.13) | (0.12) | 0.04 |
| Loss on sale of discontinued operations | (0.07) | -- | -- |
| Extraordinary item | -- | (0.13) | (0.05) |
| | ----- | ----- | ----- |
| Net income | \$ 0.36 | \$ 0.30 | \$ 0.68 |
| | ----- | ----- | ----- |

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| BALANCE SHEET DATA | 2001 | 2000 | 1999 | 1998 |
|---|-----------|-----------|-----------|---------|
| Total Assets | \$151,134 | \$134,454 | \$126,534 | \$111,1 |
| Short-Term Debt (including current portion of long-term debt) | 7,461 | 6,936 | 6,806 | 3,7 |
| Long-Term Debt | 44,560 | 42,358 | 44,285 | 30,6 |
| Subordinated Debt | 23,030 | 22,844 | -- | |
| Convertible Subordinated Debentures | -- | -- | 19,852 | 28,0 |
| Dividends per Common Share | -- | -- | -- | .0 |

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

RESULTS OF OPERATIONS - FISCAL 2001, 2000 AND 1999

The following tables set forth, for the periods indicated, the revenue and gross margin for each of the Company's four operating units included in continuing operations, as well as selected other financial statement data.

| | YEAR ENDED JUNE 30, (\$ IN MILLIONS) | | | |
|------------------------------|---|---------------------------|---------|---------------------------|
| | 2001 | | 2000 | |
| | AMOUNT | % OF TOTAL REVENUES | AMOUNT | % OF TOTAL REVENUES |
| Revenues: | | | | |
| Fuel Sales | \$318.8 | 66.6% | \$202.8 | 60.7% |
| FBOs | 99.5 | 20.8 | 73.7 | 22.0 |
| Cargo Operations | 31.3 | 6.6 | 32.5 | 9.7 |
| Government Contract Services | 28.8 | 6.0 | 25.3 | 7.6 |
| Total Revenues | \$478.4 | 100% | \$334.3 | 100% |

| | YEAR ENDED JUNE 30, (\$ IN MILLIONS) | | | |
|------------------------------|---|--------------------------|---------|--------------------------|
| | 2001 | | 2000 | |
| | AMOUNT | % OF UNIT REVENUES | AMOUNT | % OF UNIT REVENUES |
| Gross Margin (1): | | | | |
| Fuel Sales | \$ 7.4 | 2.3% | \$ 7.9 | 3.9% |
| FBOs | 15.0 | 15.1 | 11.5 | 15.6 |
| Cargo Operations | 6.8 | 21.6 | 10.0 | 30.7 |
| Government Contract Services | 5.7 | 19.7 | 5.0 | 19.9 |
| Total Gross Margin | \$ 34.9 | 7.3% | \$ 34.4 | 10.3% |

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| | AMOUNT | % OF TOTAL REVENUES | AMOUNT | % OF TOTAL REVENUES |
|--|--------|---------------------------|--------|---------------------------|
| | ----- | ----- | ----- | ----- |
| Selling, General and Administrative | \$ 7.9 | 1.7% | \$ 7.2 | 2.2% |
| Provision for Bad Debts | 3.4 | 0.7 | 5.4 | 1.6 |
| Depreciation and Amortization | 10.0 | 2.1 | 9.2 | 2.7 |
| Interest Expense and Other | 7.5 | 1.6 | 6.2 | 1.8 |
| Income from continuing operations before Income Taxes | 6.1 | 1.3 | 6.4 | 1.9 |
| Provision for Income Taxes | 2.4 | 0.5 | 2.5 | 0.8 |
| | ----- | ----- | ----- | ----- |
| Income from continuing Operations | 3.7 | 0.8 | 3.9 | 1.2 |
| (Loss) income from discontinued operations | (0.8) | (0.2) | (0.9) | (0.3) |
| Loss on sale of discontinued Operations | (0.5) | (0.1) | | |
| Extraordinary Items | -- | -- | (1.0) | (0.3) |
| | ----- | ----- | ----- | ----- |
| Net Income | \$ 2.4 | 0.5% | \$ 2.0 | 0.6% |
| | ===== | ===== | ===== | ===== |

(1) Gross Margin as used here and throughout Management's discussion includes certain selling, general and administration costs which are charged directly to the operating units, but excludes depreciation and amortization expenses and Selling, General and Administrative Expenses.

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Fiscal Year Ended June 30, 2001 Compared to Fiscal Year Ended June 30, 2000

Revenue increased 43.1% to \$478.4 million in fiscal 2001 from \$334.3 million in fiscal 2000 due to higher fuel prices and higher volume of fuel sold. Gross margin increased 1.5% to \$34.9 million in fiscal 2001 from \$34.4 million in fiscal 2000.

Revenue from fuel sales represented 66.6% of total revenue in fiscal 2001 compared to 60.7% of total revenue in fiscal 2000. Revenue from fuel sales increased 57.1% to \$318.8 million in fiscal 2001 from \$202.8 million in fiscal 2000. The increase in revenue from fuel sales was due to an increase of 18% in the average price of fuel sold and an increase of 33% in the volume of fuel sold. Volume increased in the current year due to a significant new customer added in September 2000. Gross margin from fuel sales decreased by 5.0% to \$7.4 million in fiscal 2001 from \$7.9 million in fiscal 2000 due to higher operating expenses primarily related to legal and professional fees associated with customer bankruptcy litigation and costs associated with the proposed distribution. Revenues and gross margin from fuel sales includes the activities of Mercury's contract fueling business.

Revenue from FBOs increased in fiscal 2001 by 35.0% to \$99.5 million from \$73.7 million in fiscal 2000. The increase in revenue in fiscal 2001 was primarily due to the addition of FBOs in Birmingham, Alabama in September 2000

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and Fort Wayne, Indiana in May 2000 in addition to higher fuel prices. Gross margin increased 30.3% in fiscal 2001 to \$15.0 million from \$11.5 million in fiscal 2000 based on higher revenues. Gross margin as a percentage of revenue decreased in fiscal 2001 to 15.1% from 15.6% in fiscal 2000 primarily due to higher fuel prices.

Revenue from Cargo operations decreased 3.5% in fiscal 2001 to \$31.3 million from \$32.5 million in fiscal 2000. The decrease was primarily attributable to a reduction in space brokerage revenue, primarily related to the Tower Air bankruptcy which occurred during the third quarter of fiscal 2000, and partially offset by higher handling revenue. Gross margin decreased 32.2% in fiscal 2001 to \$6.8 million from \$10.0 million in fiscal 2000, primarily due to lower space brokerage revenue and higher cargo handling costs.

Revenue from government contract services increased 13.8% to \$28.8 million from \$25.3 million in the year ago period. The increase in revenues from government contract services was primarily due to the addition of new contracts during the last twelve months and higher revenue from the Yokota, Japan contract. Partially offsetting this were two refueling contracts lost and lower Weather Observation and Forecasting revenue, based on a lower number of contracts. Gross margin from government contract services in the current period increased 12.7% to \$5.7 million from \$5.0 million last year due to higher revenues. A significant contract, Yokota, Japan, which provided \$5.1 million of revenue or 17.6% of Maytag's total revenues during fiscal year 2001, terminated in September 2001 and was not renewed.

Selling general and administrative expenses in the current period increased 9.8% to \$7.9 million from \$7.2 million in the year ago period. The increase was primarily due to higher professional fees primarily related to costs incurred in litigation settlements and other legal fees.

Provision for bad debts decreased 36.7% in fiscal 2001 to \$3.4 million from \$5.4 million in fiscal 2000 primarily due to the write off of Tower's receivable balance of \$2.7 million in the year ago period (as a result of its bankruptcy). The provision in the current year includes \$1.6 million which is attributable to a legal settlement with WPAI and \$1.0 million which is attributable to a legal settlement with Tower, both of which related to alleged preference payments made to the Company prior to bankruptcy filings. These amounts were partially offset by \$1.0 million in bad debt recoveries related to a former customer. Future periods may continue to be impacted by higher reserve requirements.

Depreciation and amortization expense increased 9.2% to \$10.0 million from \$9.2 million a year ago. The increase is primarily related to the Fort Wayne and Birmingham FBO acquisitions and various capital expenditures during the past year.

Interest expense and other (net) increased 20.7% in fiscal 2001 to \$7.5 million from \$6.2 million in fiscal 2000 due to higher initial interest rates and higher average outstanding borrowings. Additionally the Company wrote-off its investment in National Airlines due to the bankruptcy filing of National Airlines in December 2000.

Income tax expense approximated 39.0% of pretax income in both fiscal 2001 and fiscal 2000 reflecting the expected effective annual income tax rate.

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subsidiary. As a result, RPA's historic operating results (and loss on sale) have been classified as discontinued operations. In 2001, the loss on discontinued operations consisted of operating losses of \$0.8 million (net of income tax benefit of \$0.5 million) and loss on sale of \$0.5 million (net of income tax benefit of \$0.3 million). For the year ended June 30, 2000, RPA incurred operating losses of \$0.9 million (net of income tax benefit of \$0.6 million). For the year ended June 30, 1999, RPA had operating income of \$0.4 million (net of income tax expense of \$0.3 million).

Fiscal Year Ended June 30, 2000 Compared to Fiscal Year Ended June 30, 1999

Revenue increased 53.2% to \$334.3 million in fiscal 2000 from \$218.3 million in fiscal 1999 due to higher fuel prices and higher volume of fuel sold. Gross Margin increased 10.2% to \$34.4 million in fiscal 2000 from \$31.2 million in fiscal 1999.

Revenue from fuel sales represented 60.7% of total revenue in fiscal 2000 compared to 51.0% of total revenue in fiscal 1999. Revenue from fuel sales increased 82.3% to \$202.8 million in fiscal 2000 from \$111.3 million in fiscal 1999 due to higher fuel prices and higher volume of fuel sold. The increase in revenue from fuel sales was due to an increase of 22.3% in volume of fuel sold and an increase of 43.0% in the average price of fuel sold. Gross margin from fuel sales decreased by 11.3% to \$7.9 million in fiscal 2000 from \$8.9 million in fiscal 1999 primarily due to lower per gallon margins caused by rising fuel prices. Revenues and gross margin from fuel sales includes the activities of Mercury's contract fueling business.

Revenue from FBOs increased in fiscal 2000 by 36.9% to \$73.7 million from \$53.9 million in fiscal 1999. The increase in revenue in fiscal 2000 was primarily due to the addition of FBOs in Tulsa, Oklahoma; Charleston and John's Island, South Carolina; and Fort Wayne, Indiana in addition to higher fuel prices. Gross margin increased 2.1% in fiscal 2000 to \$11.5 million from \$11.3 million in fiscal 1999. Gross margin as a percentage of revenue decreased in fiscal 2000 to 15.6% from 21.0% in fiscal 1999 due to higher fuel prices and lower per gallon fuel margins.

Revenue from Cargo operations increased 17.1% in fiscal 2000 to \$32.5 million from \$27.7 million in fiscal 1999. The increase was primarily attributable to higher space brokerage revenue and higher handling revenue at LAX. Gross margin increased 73.5% in fiscal 2000 to \$10.0 million from \$5.7 million in fiscal 1999. The increase in gross margin in fiscal 2000 was primarily due to higher space brokerage revenue, higher handling revenues at LAX and elimination of losses at the Miami cargo location, which was sold in March 1999.

Revenue from government contract services declined marginally in fiscal 2000 to \$25.3 million from \$25.4 million in fiscal 1999. Gross margin from government contract services declined in fiscal 2000 by 5.0% to \$5.0 million from \$5.3 million in fiscal 1999 primarily due to lower margins from Weather Data contracts.

Selling general and administrative expenses increased by 1.5% to \$7.2 million in fiscal 2000 from \$7.1 million in fiscal 1999.

Provision for bad debts increased 214.2% in fiscal 2000 to \$5.4 million from \$1.7 million in fiscal 1999 due to the write off of Tower's receivable balance of \$2.7 million (as a result of its bankruptcy), significantly higher sales in fiscal 2000 and greater exposure due to significantly higher fuel prices during fiscal 2000 which has created a greater risk of loss due to potential bad debts related to certain airline accounts.

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Depreciation and amortization expense increased 10.4% in fiscal 2000 to \$9.2 million from \$8.3 million in fiscal 1999 primarily due to the Burbank FBO expansion during fiscal 1999, acquisitions of Jackson and Charleston FBOs in fiscal 1999, acquisition of Tulsa FBO in October 1999 and various capital expenditures.

Interest expense (net) increased 46.6% in fiscal 2000 to \$6.2 million from \$4.2 million in fiscal 1999 due to higher interest rates and higher average outstanding borrowings.

Income tax expense approximated 39.0% of pretax income in both fiscal 2000 and fiscal 1999 reflecting the expected effective annual income tax rate.

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The extraordinary item of \$979,000 in fiscal 2000 consisted of charges associated with the redemption of the Company's 7 3/4% convertible subordinated debentures in September 1999. The charge includes a \$780,000 redemption premium plus write off of capitalized fees of \$824,000 less the related tax benefit of \$625,000. The extraordinary item of \$483,000 in fiscal 1999 consisted of a charge of \$792,000 related to the cost of repurchasing and retiring convertible subordinated debentures in excess of par value plus write off of related bond issuance costs net of the related income tax benefit of \$309,000.

LIQUIDITY AND CAPITAL RESOURCES

The events of September 11, 2001 have had a significant impact on the aviation industry and, as a result, have impacted the Company's operations as well. In the first few days following September 11, revenue from the Company's fuel sales, cargo and FBO operations were negligible. Since that time, the Company's operations have begun to return to normal. In view of the uncertainty of the ultimate impact upon the aviation industry, the long term impact to the Company's operations cannot be determined at this time.

On March 7, 2001, the Company announced its plan to create an independent publicly traded company, MercFuel, Inc. MercFuel, Inc. was organized in Delaware on October 27, 2000 as a wholly owned subsidiary of the Company. On January 1, 2001, the Company transferred to MercFuel, Inc. the assets and liabilities of its Fuel Sales division. On April 30, 2001, MercFuel, Inc. agreed to sell 239,942 shares of common stock in a private placement at a per share price of \$4.35, the net proceeds of which are \$860,000. The sale will be consummated at such time as the Company's lenders consent to that offering. On May 15, 2001, the Company contributed \$4.0 million of equity to MercFuel, Inc. in the form of cancellation of intercompany debt payable to the Company. On May 16, 2001, MercFuel filed a registration statement related the proposed sale of 1,200,000 shares of common stock (along with an additional 180,000 shares to cover over-allotments and an option issued to the underwriter to purchase 120,000 shares, exercisable one year after the effective date of the offering at a price equal to 140% of the initial public offering price). There can be no assurance that the Company will be able to complete the initial public offering, however, if the offering is completed, the Company will own at least 80.1% of MercFuel's outstanding common stock. The Company currently intends, subject to satisfactory resolution of certain conditions, to distribute (the "Distribution") all of the shares of MercFuel common stock that the Company owns to the Company's stockholders no earlier than six months after MercFuel's initial public offering. The Distribution is subject to consent by the Company's subordinated debt holder.

Mercury has historically financed its operations primarily through

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operating cash flow, bank debt and various public and private placement of bonds and subordinated debt. Mercury's cash balance at June 30, 2001 was \$3.9 million.

Net cash provided by operating activities was \$13.5 million, during fiscal 2001. The primary source of net cash provided by operating activities was net income before loss from discontinued operations plus depreciation and amortization totaling \$13.8 million, bad debt expense of \$3.4 million, an increase in accounts payable of \$5.9 million and an increase in accrued expense and other current liabilities of \$4.7 million. The primary use of cash from operating activities was an increase in trade and other accounts receivable of \$14.1 million.

Net cash used in investing activities was \$15.4 million during fiscal 2001. The primary uses of cash from investing activities included \$6.5 million in additions to property, equipment and leaseholds and \$10.4 million in acquisitions of businesses, net of cash acquired.

Net cash provided by financing activities was \$3.2 million during fiscal 2001. The primary source of cash from financing activities during this period was proceeds from long-term debt of \$12.0 million. The primary use of cash from financing activities was the reduction of long-term debt of \$9.2 million.

Net cash provided by Discontinued Operations was \$0.4 million in fiscal 2001.

On September 10, 1999, the Company issued, in a private placement, \$24.0 million Senior Subordinated 12% Note ("the Note") due 2006 with detachable warrants to acquire 503,126 shares of the Company's common stock exercisable at \$6.50 per share for seven years. Proceeds of the Note were used primarily to redeem \$19.5 million of the Company's 7 3/4% convertible subordinated debentures due February 1, 2006 plus a redemption premium of 4% totaling \$780,000, pay accrued interest and pay expenses of the transaction. The Note balance is net of warrants valued at \$1.3 million less \$336,000 amortized as interest expense in fiscal 2000 and 2001.

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On March 2, 1999, the Company entered into an \$80.0 million senior secured credit facility with a consortium of four banks. At June 30, 2001, this facility includes up to \$35.0 million Revolving Credit ("Revolving Credit"), a term loan with a balance of \$15.2 million ("Term Loan") and an acquisition facility with a balance of \$18.2 million ("Acquisition Facility"). These facilities mature in March 2004. The Term Loan is payable over five years in quarterly installments of principal of \$1.0 million in year one with quarterly installments increasing each year thereafter by \$125,000 with a final installment in March 2004. Balances outstanding under the Revolving Credit and Acquisition Facility will be due in March 2004. Interest rates may vary depending upon the Company's leverage ratio. Currently the interest rate is equal to the Eurodollar rate plus 2.5% or the Banks base rate (equivalent to the prime rate which was 7.0 % at June 30, 2001). At June 30, 2001 current portion of long-term debt pertaining to this facility is \$5.1 million and long-term debt includes \$10.1 million of the Term Loan and \$18.2 million of the Acquisition Facility.

On April 2, 1998, the Company raised \$19.0 million from a tax exempt bond financing pursuant to a loan agreement between the Company and the California Economic Development Financing Authority, ("CEDFA"). These funds were obtained to finance the Company's LAX Cargo warehouse expansion and expansion of its Burbank FBO. The loan carries a variable rate which is based on a weekly

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remarketing of the tax exempt bonds issued by CEDFA. Since the issuance of the bond, the per annum interest rate has averaged 3.15% through June 30, 2001. The Company's senior bank group has issued a one-year, renewable letter of credit in the amount of approximately \$16.8 million to secure the Company's obligations under the loan agreement. Principal payments of \$500,000 are payable semi-annually with a redemption of \$4.0 million at the end of the fifteenth year. At June 30, 2001, the balance was \$16.0 million.

On September 26, 2001, the Company announced they have agreed to enter into a financing arrangement to issue convertible subordinated debentures. These convertible subordinated debentures are expected to have a principal amount of \$110.0 million, discounted to \$71.9 million and are expected to yield 11.7% to maturity (which includes interest paid at the rate of 7% per annum on the principal amount plus amortization of the discount). The convertible subordinated debentures can be convertible into Mercury Air Group's common stock, subsequent to September 30, 2004, at \$21.50 per share. The funding of this arrangement is expected to occur at different intervals with \$25.0 million (\$38.5 million principal) to fund in October 2001 and the remaining amount to be funded within one year. The Company anticipates using the proceeds from the sale of these debentures to repay the Company's subordinated indebtedness, restructure the Company's senior indebtedness, and for any potential future acquisitions.

In connection with the proposed Distribution, the Company has executed term sheets with two financial institutions to replace its senior credit facility. The new agreements include a \$20.0 million revolving senior credit facility which will be entered into by MercFuel, Inc. and a \$60.0 million facility which will be entered into by the Company. The revolving credit facility will be secured by substantially all of MercFuel, Inc.'s assets. The revolving credit facility will mature in two-to-four years, at MercFuel, Inc.'s option, and will be subject to certain financial covenants, including maintenance of a minimum level of tangible net worth. The Company's facility will mature in March 2006 and will include a term loan of \$35.0 million and a revolver of \$25.0 million. The facility will be secured by substantially all of the Company's assets excluding MercFuel assets, and will be subject to certain financial covenants, including maintenance of minimum net worth, maximum leverage ratio, minimum fixed charge coverage ratio and minimum quick ratio.

Mercury generally purchases fuel using credit terms which on average are shorter than the credit terms Mercury generally offers its customers. As a result, Mercury requires access to sufficient credit facilities which may need to increase in the future as Mercury expands its operations. The amount of working capital consumed by Mercury's accounts receivable has depended and will depend primarily on the quantity of fuel sold, the price of fuel, Mercury's extension of credit, customer compliance with Mercury's credit terms and credit terms provided by Mercury's suppliers. Any increase in the quantity or price of fuel sold, any increase in credit extended, any reduction in credit terms provided by Mercury's suppliers or any substantial customer noncompliance with credit terms will result in a corresponding increase in Mercury's need for working capital. Under these circumstances, Mercury's liquidity could be adversely affected unless Mercury is able to increase vendor credit or increase lending limits under the Company's revolving credit facility. Mercury believes, however, that the Company's current financing arrangements and vendor credit should provide the Company with sufficient liquidity in the event of a continued major temporary surge in oil prices. However, to the extent that credit facilities are utilized to fund working capital requirements Mercury will incur additional interest expense.

The Company's accounts receivable balance was \$55.0 million at June 30, 2001. Accounts receivable is comprised primarily of trade receivables from customers and is net of an allowance for doubtful accounts. Mercury's credit risk is based in part on the following: 1) substantially all receivables are

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related to a single industry (aviation), 2) there is a concentration of credit risk as there are several customers who at any time have significant balances owed to the Company, and 3) significant balances are owed by certain customers that are not adequately capitalized.

The fuel sales division accounted for approximately 67% of the total Company revenue in fiscal 2001. For the year ended June 30, 2001, sales to certain fuel sales customers make up approximately 39% of the Company's total accounts receivable due from what the Company defines as smaller and generally less well-established or well-capitalized airlines, including certain foreign, regional, commuter and start-up airlines, which may be less creditworthy than larger, well-established and well-capitalized airlines. These customers are more affected by fluctuations in the economy in general and in the aviation industry specifically. For example, a material rise in the price of aviation fuel tends to more adversely impact these types of customers. To the extent that Mercury's airline

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customers are not able to immediately adjust their business operations to reflect increased operating costs, they could take relatively longer to pay the Company's accounts receivable. Such payment delays would further increase Mercury's working capital demands. In some cases, the impact of such economic fluctuations could materially impair the financial stability of an airline customer such that it would be unable to pay amounts owed to the Company and could result in such airline customer filing for bankruptcy protection. In that event, Mercury could incur significant losses related to the uncollectability of the receivables. Mercury has incurred in the past and is likely to continue to incur losses as the result of the business failure of a customer. Mercury assesses its credit portfolio on an ongoing basis and establishes allowances which the Company believes are adequate to absorb potential credit problems that can be reasonably anticipated. This assessment includes an analysis of past due accounts as well as a review of accounts with significant balances. Reserves are established for all or some portion of past due balances based upon various factors including the extent of delinquency, financial conditions of delinquent customers and amounts of insurance and collateral, if any.

Accounts receivable days outstanding were 42 days and 45 days as of June 30, 2001 and 2000, respectively. Accounts receivable days outstanding have historically been impacted by a high volume of fuel sales to customers with extended payment terms. However, during the current period, the Company added a large customer, AirTran Airways, whose terms are prepaid. The terms of the prepayment provide for weekly payments equal to the following weeks' estimated sales. This prepaid customer accounted for approximately 14% of the Company's consolidated revenue for the year ended June 30, 2001. During the year, the Company also reduced the maximum amount of available credit to National Airlines based on their volume of fuel purchased. These factors significantly reduced the accounts receivable days outstanding.

The Company's recurring capital expenditure requirements have been related to the acquisition of refueling and ground handling equipment for both commercial and government contract services operations. During fiscal 1999, 2000 and 2001, respectively, the Company spent approximately \$2.1 million, \$2.7 million and \$840,000 to purchase refueling and ground handling equipment for its commercial and government contract services operations. During the last three fiscal years, the Company has also made substantial expenditures to acquire and construct facilities and businesses to expand its operations. On August 1, 1998, Maytag acquired thirty-eight government contracts and related assets from Weather Data for \$2.5 million in cash and \$1.0 million in stock (subsequently

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increased by 22,565 shares in September 1999 since the market value of the shares originally issued was less than \$1.0 million on August 1, 1999). On November 30, 1998, the Company acquired substantially all the assets of an FBO in Jackson, Mississippi for \$4.5 million in cash. In April 2000, the company acquired the assets of an FBO located in Fort Wayne, Indiana for \$3.9 million in cash which was funded under its acquisition line. In October 1999, the Company acquired assets of an FBO in Tulsa, Oklahoma for \$2.4 million in cash which was funded under its acquisition line. A second part to this closing occurred in July 2000 for \$3.8 million which was funded under the company's acquisition line. In October 1999, the company acquired certain FBO assets at Charleston International Airport and John's Island Executive Airport in South Carolina for \$700,000 in cash which was funded under its acquisition line. In September 2000, the company acquired the Birmingham, Alabama FBO assets from Raytheon Aircraft Services for \$6.6 million in cash, which was funded from its acquisition line.

On August 10, 2001, MercFuel, Inc. entered into an agreement with a provider of hardware and software applications ("System Provider"), for the development and exclusive license of an aviation fuel management system. The agreement requires MercFuel, Inc. to pay the System Provider \$25,000 by October 1, 2001, and enter into a non-interest bearing note in the amount of \$750,000, payable in 24 equal monthly payments beginning in August 2002 (the present value of which is \$640,000, assuming an imputed interest rate of 8%). The note is convertible, at MercFuel's option, at any time after the Distribution into 125,000 shares of MercFuel common stock. MercFuel is also required to attempt to register the shares. In addition, if MercFuel does not complete an offering of its common shares by December 31, 2001, the agreement shall be terminated.

In fiscal 1998, the Company began construction of a new FBO operation in Burbank, California at a cost of approximately \$11.2 million, \$1.8 million spent in fiscal 2000, \$7.2 million spent in fiscal 1999 and \$2.2 million spent in fiscal 1998. This project was completed in fiscal 2000. The Company also retrofitted or replaced a number of fuel farms during fiscal 1999 at a cost of approximately \$3.4 million.

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Absent a major prolonged surge in oil prices, currently unforeseen impact resulting from the events of September 11, 2001, or a capital intensive acquisition, the Company believes its operating cash flow, senior credit facility, vendor credit and cash balance will provide it with sufficient liquidity during the next twelve months. In the event that fuel prices increase significantly for an extended period of time, the Company's liquidity could be adversely affected unless the Company is able to increase vendor credit or increase lending limits under its revolving credit facility. The Company believes, however, its Revolver and vendor credit should provide it with sufficient liquidity in the event of a major temporary surge in oil prices.

Inflation

The Company believes that inflation has not had a significant effect on its results of operations during the past three fiscal years.

Forward-Looking Statements

Statements contained in this Annual Report on Form 10-K which are not historical facts are forward-looking statements. In addition, Mercury, from time-to-time, makes forward-looking statements concerning its expected future operations and performance and other developments. Such forward-looking statements are necessarily estimates reflecting Mercury's best judgment based

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upon current information and involve a number of risks and uncertainties, and there can be no assurance that other factors will not affect the accuracy of such forward-looking statements. While it is impossible to identify all such factors, factors which could cause actual results to differ materially from those estimated by Mercury include, but are not limited to, risks associated with acquisitions, the financial condition of customers, non-renewal of contracts, government regulation, as well as operating risks, general conditions in the economy and capital markets, and other factors which may be identified from time-to-time in Mercury's Securities and Exchange Commission filings and other public announcements.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK.

The Company does not currently utilize material derivative financial instruments which expose the Company to significant market risk. However, the Company's cash flow, earnings, and the fair value of its debt, may be adversely effected due to changes in interest rates with respect to its long-term debt. The table below presents principal cash flows and related weighted average interest rates of the Company's long-term debt at June 30, 2001 by expected maturity dates. Weighted average variable rates are based on rates in effect at June 30, 2001. These rates should not be considered a predictor of actual future interest rates.

| | Expected Maturity Date | | | | | |
|---------------------|------------------------|------------------|------------------|------------------|------------------|-------------------|
| | JUNE-02 ----- | JUNE-03 ----- | JUNE-04 ----- | JUNE-05 ----- | JUNE-06 ----- | THEREAFT ----- |
| Fixed Rate | | | | | | |
| Subordinated Note | 0 | 0 | 0 | 0 | 0 | \$24,000,0 |
| Average Interest | | | | | | |
| Rate | 12.0% | 12.0% | 12.0% | 12.0% | 12.0% | 12 |
| Fixed Rate Other | | | | | | |
| Debt | \$ 311,000 | \$ 326,000 | \$ 199,000 | \$ 26,000 | \$ 26,000 | \$ 200,0 |
| Average Interest | | | | | | |
| Rate | 8.39% | 8.52% | 8.83% | 9.14% | 9.14% | 9. |
| Variable Rate | | | | | | |
| Tax Exempt Bonds(1) | \$1,000,000 | \$1,000,000 | \$ 1,000,000 | \$1,000,000 | \$1,000,000 | \$11,000,0 |
| Average | | | | | | |
| Interest Rate | 3.20% | 3.20% | 3.20% | 3.20% | 3.20% | 3. |
| Variable Rate | | | | | | |
| Other Debt(2) | \$5,125,000 | \$5,625,000 | \$22,654,000 | 0 | 0 | |
| Average | | | | | | |
| Interest Rate | 6.25% | 6.25% | 6.25% | 0 | 0 | |

(1) The interest rate is based upon a weekly remarketing of the bonds.

(2) Consists of debt under which interest rates will fluctuate based upon changes in the prime rate or LIBOR.

In making its determination as to the balance of fixed and variable rate debt, the Company considers the interest rate environment (including interest rate trends), borrowing alternatives and relative pricing. The Company periodically monitors the balance of fixed and variable rate debt, and can make appropriate corrections either pursuant to the terms of debt agreements or through the use of swaps and other financial instruments

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ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.

See Part IV, Item 14, pages F1 through F20 immediately following.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE.

None.

PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT.

Reference is made to the information set forth under the caption "Election of Directors" of the Company's Proxy Statement for the annual meeting scheduled in November 2001 (the "Proxy Statement") for a description of the directors and executive officers of the Company, which information is incorporated herein by reference.

ITEM 11. EXECUTIVE COMPENSATION.

Reference is made to the information set forth under the caption "Executive Compensation" of the Proxy Statement, which information is incorporated herein by reference.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT.

Reference is made to the table, including the footnotes thereto, set forth under the caption "Election of Directors" of the Proxy Statement, for certain information respecting ownership of stock of the Company by management and certain shareholders, which table and footnotes are incorporated herein by reference.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS.

Reference is made to the information set forth under the caption "Certain Transactions" of the Proxy Statement for certain information with respect to relationships and related transactions, which information is incorporated herein by reference.

PART IV

ITEM 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES AND REPORTS ON FORM 8-K:

(a) (1) Financial Statements

| | |
|--|--|
| Independent Auditors' Report..... | |
| Consolidated Balance Sheets as of June 30, 2001 and 2000..... | |
| Consolidated Statements of Income for each of the three years in the period ended June 30, 2001..... | |
| Consolidated Statements of Cash Flows for each of the three years in the period ended June 30, 2001..... | |
| Consolidated Statements of Stockholders' Equity for each of the three years in the period ended June 30, 2001..... | |
| Notes to Consolidated Financial Statements for the three years ended June 30, 2001..... | |

(a) (2) Supplemental Schedule for each of the three years in the period ended June 30, 2001:

| | |
|--|--|
| Schedule II - Valuation and Qualifying Accounts..... | |
|--|--|

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All other items are not included in this Form 10-K either because they are not applicable or are included in the information as set forth in the Consolidated Financial Statements or in the Notes to Consolidated Financial Statements.

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- Item 14 (a) Exhibits and Exhibit List
(b) Reports on Form 8-K

| EXHIBIT NO. ----- | DESCRIPTION ----- |
|-------------------------|---|
| 2.1 | Agreement and Plan of Merger adopted January 9, 2001. (17) |
| 2.2 | Certificate of Merger. (17) |
| 3.1 | Bylaws of Company adopted January 9, 2001. (17) |
| 3.2 | Certificate of Incorporation. (17) |
| 4.1 | Loan Agreement between California Economic Development Financing Authority and Mercury Air Group, Inc. relating to \$19,000,000 California Economic Development Financing Authority Variable Rate Demand Airport Facilities Revenue Bonds, Series 1998 (Mercury Air Group, Inc. Project) dated as of April 1, 1998. (2) |
| 4.2 | Securities Purchase Agreement dated September 10, 1999 by and among Mercury Air Group, Inc. and J.H. Whitney Mezzanine Fund, L.P. (12) |
| 4.3 | Amendment No. 1 dated as of September 30, 2000 by and between J.H. Whitney Mezzanine, L.P. and Mercury Air Group, Inc. to the Securities Agreement. (16) |
| 4.4 | Waiver and Consent Agreement dated as of December 29, 2000 among Mercury Air Group, Inc. and J.H. Whitney Mezzanine Fund, L.P. (17) |
| 4.5 | Waiver and Consent Agreement dated as of July 2, 2001 among Mercury Air Group, Inc. and J.H. Whitney Mezzanine Fund, L.P. |
| 4.6 | Waiver Agreement dated as of September 25, 2001 among Mercury Air Group, Inc. and J.H. Whitney Mezzanine Fund, L.P. |
| 10.1 | Company's 1990 Long-Term Incentive Plan. (4)* |
| 10.2 | Company's 1990 Directors Stock Option Plan. (1)* |
| 10.3 | Lease for 6851 West Imperial Highway, Los Angeles, California. (3) |
| 10.4 | Memorandum Dated September 15, 1997 regarding Summary of Officer Life Insurance Policies with Benefits Payable to Officers or Their Designated Beneficiaries. (8)* |

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- 10.5 Employment Agreement dated November 15, 1994 between the Company and Joseph Czyzyk. (9)*
- 10.6 Non-Qualified Stock Option Agreement dated March 21, 1996, by and between Frederick H. Kopko and Mercury Air Group, Inc. (6) *
- 10.7 Company's 1998 Long-Term Incentive Plan. (10) *
- 10.8 Company's 1998 Directors Stock Option Plan. (10) *
- 10.9 Amendment to Employment Agreement by and between Mercury Air Group, Inc. and Joseph A. Czyzyk dated October 15, 1998. (11) *
- 10.10 Amendment No. 2 to Employment Agreement by and between Mercury Air Group, Inc. and Joseph A. Czyzyk dated April 12, 1999. (11) *
- 10.11 Revolving Credit and Term Loan Agreement dated as of March 2, 1999 by and among Mercury Air Group, Inc., The Banks listed on Schedule 1 thereto, and The Fleet National Bank f/k/a BankBoston, N.A., as Agent. (11)
- 10.12 First Amendment to Revolving Credit and Term Loan Agreement dated as of September 10, 1999. (14)
- 10.13 Second Amendment to Revolving Credit and Term Loan Agreement dated as of March 31, 2000. (14)
- 10.14 Third Amendment, Waiver and Consent to Revolving Credit and Term Loan Agreement dated as of August 11, 2000. (14)
- 10.15 The Company's 401(k) Plan consisting of CNA Trust Corporation. Regional Prototype Defined Contribution Plan and Trust and Adoption Agreement. (14)*
- 10.16 Amendment No. 3 to Employment Agreement by and between Mercury Air Group, Inc. and Joseph A. Czyzyk dated September 11, 2000. (15)*
- 10.17 Employment Agreement dated July 31, 2000 between the Company and Dr. Philip J. Fagan. (15)*
- 10.18 Fourth Amendment to Revolving Credit and Term Loan Agreement dated as of November 14, 2000. (16)

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EXHIBIT

NO.

DESCRIPTION

- | EXHIBIT NO. | DESCRIPTION |
|-------------|--|
| 10.19 | Amendment No. 1 to Mercury Air Group, Inc. 1998 Long-Term Incentive Option Plan as of August 22, 2000. (16)* |
| 10.20 | Amendment No. 1 to Mercury Air Group, Inc. 1998 Directors Stock Option Plan as of August 22, 2000. (16)* |

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- 10.21 Limited Waiver letter Agreement to Revolving Credit and Term Loan Agreement dated as of September 21, 2001.
- 10.22 Agreement with Management & Report Technologies, Inc. (22)
- 22.1 Subsidiaries of Registrant.
- 23.1 Consent of Deloitte & Touche, LLP with respect to incorporation of their report on the audited financial statements contained in this Annual Report on Form 10-K in the Company's Registration Statement on Form S-8 (Registration Statement No. 33-69414).
- 99.1 Partnership Agreement dated as of July 27, 2000 of CFK Partners by and among Philip J. Fagan, M.D., Frederick H. Kopko, Jr. and Joseph A. Czyzyk. (13)

* Denotes managements contract or compensation plan or arrangement.

- (1) Such document was previously filed as Appendix A to the Company's Proxy Statement for the December 10, 1993 Annual Meeting of Shareholders and is incorporated herein by reference.
- (2) All such documents were previously filed as Exhibits to the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 1998 and are incorporated herein by reference.
- (3) All such documents were previously filed as Exhibits to the Company's Registration Statement No. 33-39044 on Form S-2 and are incorporated herein by reference.
- (4) Such document was previously filed as Appendix A to the Company's Proxy Statement for the December 2, 1992 Annual Meeting of Shareholders.
- (5) All such documents were previously filed as Exhibits to the Company's Registration Statement No. 33-65085 on Form S-1 and are incorporated herein by reference.
- (6) All such documents were previously filed as Exhibits to the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 1996 and are incorporated herein by reference.
- (7) All such documents were previously filed as Exhibits to the Company's Report on Form 8-K filed September 13, 1996 and are incorporated herein by reference.
- (8) Such document was previously filed as an Exhibit to the Company's Annual Report on Form 10-K for the year ended June 30, 1997 and is incorporated herein by reference.
- (9) All such documents were previously filed as an Exhibit to the Company's Annual Report on Form 10-K for the year ended June 30, 1998 and is incorporated herein by reference.
- (10) Such document was previously filed as Appendix A to the Company's Proxy Statement for the December 3, 1998 Annual Meeting of Shareholders and incorporated herein by reference.
- (11) All such documents were previously filed as an Exhibit to the

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Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 1999 and incorporated herein by reference.

- (12) All such documents were previously filed as an Exhibit to the Company's Annual Report on Form 10-K for the year ended June 30, 1999 and is incorporated herein by reference.

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- (13) Such document was previously filed as an Exhibit to the Company's current Report on Form 8-K on August 11, 2000 and is incorporated herein by reference.
- (14) All such documents were previously filed as an Exhibit to the Company's Annual Report on Form 10-K for the year ended June 30, 2000 and is incorporated herein by reference.
- (15) All such documents were previously filed as an Exhibit to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2000 and incorporated herein by reference.
- (16) All such documents were previously filed as an Exhibit to the Company's Quarterly Report on Form 10-Q for the quarter ended December 31, 2001 and incorporated herein by reference.
- (17) All such documents were previously filed as an Exhibit to the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2001 and incorporated herein by reference.
- (18) Such document was previously filed as an Exhibit to the Company's Amendment No. 2 in Registration Statement No. 33-60992 on Form S-1 and is incorporated herein by reference.

(b) Reports on Form 8-K:

None

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Company has duly caused this Report to be signed on its behalf by the undersigned thereunto duly authorized in the City of Los Angeles, State of California, on September 27, 2001.

MERCURY AIR GROUP, INC.

By: /s/ Philip J. Fagan, Jr., M.D

Philip J. Fagan, Jr., M.D
Chairman of the Board

Pursuant to the requirements of the Securities Exchange Act of 1934,

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this Report has been signed by the following persons in the capacities and on the dates indicated:

Signers:

Chairman of the Board

/s/ Philip J. Fagan, Jr. M.D.

Philip J. Fagan, Jr., M.D.
Chairman of the Board

Dated: September 27, 2001

Principal Executive Officer and Director:

/s/ Joseph Czyzyk

Joseph Czyzyk
Chief Executive Officer and Director

Dated: September 27, 2001

Principal Financial and Accounting Officer:

/s/ Randolph E. Ajer

Randolph E. Ajer
Executive Vice President and Treasurer

Dated: September 27, 2001

Additional Directors:

/s/ Frederick H. Kopko, Jr.

Frederick H. Kopko, Jr.
Director

Dated: September 27, 2001

/s/ Robert L. List

Robert L. List
Director

Dated: September 27, 2001

/s/ Harold Bowling

Harold Bowling
Director

Dated: September 27, 2001

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INDEPENDENT AUDITORS' REPORT

The Board of Directors and Stockholders
Mercury Air Group, Inc.

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Los Angeles, California

We have audited the accompanying consolidated balance sheets of Mercury Air Group, Inc. and subsidiaries as of June 30, 2001 and 2000, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended June 30, 2001. Our audits also included the financial statement schedule listed in the Index at Item 14. These financial statements and the financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and the financial statement schedule based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. 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, such consolidated financial statements present fairly, in all material respects, the financial position of Mercury Air Group, Inc. and subsidiaries as of June 30, 2001 and 2000, and the results of their operations and their cash flows for each of the three years in the period ended June 30, 2001 in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

Deloitte & Touche LLP

Los Angeles, California
September 26, 2001

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MERCURY AIR GROUP, INC. AND SUBSIDIARIES CONSOLIDATED BALANCE SHEETS

| | JUNE 30, 2001 |
|---|------------------|
| | ----- |
| ASSETS | |
| CURRENT ASSETS: | |
| Cash and cash equivalents | \$ 3,886,000 |
| Trade accounts receivable, net of allowance for doubtful accounts of \$1,653,000 at 6/30/01 and \$2,291,000 at 6/30/00 | 55,040,000 |
| Inventories, principally aviation fuel | 4,069,000 |
| Prepaid expenses and other current assets | 2,882,000 |
| Net assets of discontinued operations (Note 2) | 4,338,000 |
| | ----- |
| Total current assets | 70,215,000 |
| PROPERTY, EQUIPMENT AND LEASEHOLDS , net of | |

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| | |
|---|----------------|
| accumulated depreciation and amortization of \$52,165,000 at 6/30/01 and \$43,397,000 at 6/30/00 (Note 3, 7, and 10) | 71,779,000 |
| OTHER ASSETS, net (Notes 4 and 10) | 9,140,000 |
| | \$ 151,134,000 |
| | ===== |

LIABILITIES AND STOCKHOLDERS' EQUITY

CURRENT LIABILITIES:

| | |
|---|---------------|
| Accounts payable | \$ 31,764,000 |
| Accrued expenses and other current liabilities (Note 5) | 10,357,000 |
| Current portion of long-term debt (Note 7) | 7,461,000 |
| | ----- |
| Total current liabilities | 49,582,000 |

| | |
|---|------------|
| LONG-TERM DEBT (Notes 7 and 8) | 44,560,000 |
| DEFERRED INCOME TAXES (Note 6) | 380,000 |
| SENIOR SUBORDINATED NOTES (Note 8) | 23,030,000 |
| COMMITMENTS AND CONTINGENCIES (Note 11) | |

STOCKHOLDERS' EQUITY (Note 9):

| | |
|--|------------|
| Preferred Stock - \$.01 par value; authorized 3,000,000 shares; no shares outstanding | |
| Common Stock - \$.01 par value; authorized 18,000,000 shares; Outstanding 6,576,680 shares at 6/30/01; Outstanding 6,472,955 shares at 6/30/00 | 66,000 |
| Additional paid-in capital | 21,442,000 |
| Retained earnings | 12,835,000 |
| Accumulated other comprehensive income | (228,000) |
| Notes receivable from sale of stock | (533,000) |
| | ----- |
| Total stockholders' equity | 33,582,000 |

\$ 151,134,000
=====

See accompanying notes to consolidated financial statements.

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MERCURY AIR GROUP, INC. AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF INCOME

| | YEAR ENDED | |
|---------------------|----------------|----------------|
| | 2001 | 2000 |
| Sales and Revenues: | | |
| Sales | \$ 385,868,000 | \$ 254,470,000 |
| Service revenues | 92,578,000 | 79,850,000 |
| | 478,446,000 | 334,320,000 |
| Costs and Expenses: | | |

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| | | |
|--|--------------|---------|
| Cost of sales | 347,456,000 | 223,05 |
| Operating expenses | 96,048,000 | 76,86 |
| | ----- | ----- |
| | 443,504,000 | 299,91 |
| | ----- | ----- |
| Gross Margin (Excluding depreciation and amortization) | 34,942,000 | 34,41 |
| | ----- | ----- |
| Expenses (Income): | | |
| Selling, general and administrative | 7,929,000 | 7,22 |
| Provision for bad debts | 3,425,000 | 5,40 |
| Depreciation and amortization | 10,008,000 | 9,16 |
| Interest expense | 7,184,000 | 6,29 |
| Loss on investment | 300,000 | |
| Interest income | (48,000) | (13 |
| | ----- | ----- |
| | 28,798,000 | 27,95 |
| | ----- | ----- |
| Income from Continuing Operations Before Provision for Income Taxes and Extraordinary Item | 6,144,000 | 6,46 |
| Provision for Income Taxes (Note 6) | 2,397,000 | 2,52 |
| | ----- | ----- |
| Income from Continuing Operations | 3,747,000 | 3,94 |
| Discontinued Operations (Note 2): | | |
| (Loss) income from discontinued operations, net of income tax (benefit) charge of (\$548,000) in 2001, (\$597,000) in 2000 and \$251,000 in 1999 | (858,000) | (93 |
| Loss on sale of discontinued operations, net of income tax benefit of \$305,000 | (477,000) | |
| | ----- | ----- |
| Income before Extraordinary Item | 2,412,000 | 3,00 |
| Extraordinary item less applicable income tax benefit of \$625,000 and \$309,000 (Note 8) | -- | (97 |
| | ----- | ----- |
| Net Income | \$ 2,412,000 | \$ 2,02 |
| | ===== | ===== |
| Net Income Per Common Share (Note 13): | | |
| Basic: | | |
| From Continuing Operations | \$ 0.57 | \$ |
| (Loss) income from Discontinued Operations | (0.13) | |
| Loss on sale of discontinued operations | (0.07) | |
| | ----- | ----- |
| Income before Extraordinary Item | 0.37 | |
| Extraordinary Item | -- | |
| | ----- | ----- |
| Net Income | \$ 0.37 | \$ |
| | ===== | ===== |
| Diluted: | | |
| From Continuing Operations | \$ 0.56 | \$ |
| (Loss) income from Discontinued Operations | (0.13) | |
| Loss on sale Discontinued Operations | (0.07) | |
| | ----- | ----- |
| Income before Extraordinary Item | 0.36 | |
| Extraordinary Item | -- | |
| | ----- | ----- |
| Net Income | \$ 0.36 | \$ |
| | ===== | ===== |

See accompanying notes to consolidated financial statements.

MERCURY AIR GROUP, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOW

| | YEAR ENDED | |
|---|--------------|--------------|
| | 2001 | 2000 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | \$ 2,412,000 | \$ 2,000,000 |
| Less: Income (loss) from discontinued operations before extraordinary Item | (1,335,000) | (9,000,000) |
| | 3,747,000 | 2,900,000 |
| Income from continuing operations | | 2,900,000 |
| Non-cash component of extraordinary charge | | 8,000,000 |
| Adjustments to derive cash flow from operating activities: | | |
| Bad debt expense | 3,425,000 | 5,400,000 |
| Depreciation and amortization | 10,008,000 | 9,100,000 |
| Deferred income taxes | 270,000 | (1,000,000) |
| Compensation expense related to remeasurement of stock options | | |
| Amortization of Senior Subordinated Note discount | 186,000 | 1,000,000 |
| Changes in operating assets and liabilities: | | |
| Trade and other accounts receivable | (14,050,000) | (3,900,000) |
| Inventories | (641,000) | (1,500,000) |
| Prepaid expenses and other current assets | 22,000 | 5,000,000 |
| Accounts payable | 5,924,000 | 4,500,000 |
| Income taxes payable | | (9,000,000) |
| Accrued expenses and other current liabilities | 4,656,000 | 1,000,000 |
| | 13,547,000 | 17,300,000 |
| Net cash provided by operating activities | | |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Restricted cash-tax exempt bond | | 7,000,000 |
| Increase to other assets | 1,499,000 | (1,500,000) |
| Acquisition of businesses, net of cash acquired (Note 10) | (10,400,000) | (7,000,000) |
| Additions to property, equipment and leaseholds | (6,471,000) | (10,600,000) |
| | (15,372,000) | (18,300,000) |
| Net cash used in investing activities | | |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Proceeds from long-term debt | 11,969,000 | 10,600,000 |
| Reduction of long-term debt | (9,242,000) | (12,400,000) |
| Capitalized loan fee | | (1,800,000) |
| Payment received from notes receivable - officers | 75,000 | |
| Reduction of convertible subordinated debentures | | (19,500,000) |
| Repurchase of common stock | | (1,800,000) |
| Proceeds from senior subordinated note | | 24,000,000 |
| Proceeds from issuance of common stock | 430,000 | |
| | 3,232,000 | (9,000,000) |
| Net cash provided by (used in) financing activities | | |

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| | | |
|--|--------------|--------|
| Net Cash provided by (used in) Discontinued Operations | 398,000 | (4 |
| NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS FROM CONTINUING OPERATIONS | 1,407,000 | (1,9 |
| CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR | 2,081,000 | 4,4 |
| CASH AND CASH EQUIVALENTS, END OF YEAR | \$ 3,886,000 | \$ 2,0 |
| CASH PAID DURING THE PERIOD: | | |
| Interest | \$ 7,306,000 | \$ 6,8 |
| Income taxes | \$ 3,000 | \$ 2,3 |
| SUPPLEMENTAL SCHEDULE OF NON-CASH INVESTING AND FINANCING ACTIVITIES: | | |
| Issuance of 124,224 shares of common stock in fiscal 1999 and an additional 22,565 shares in fiscal 2000 for acquisition of assets of Weather Data (note 10) | | \$ 1 |
| Conversion of 50 debentures into 6,854 shares of common stock | | |
| Conversion of 318 debentures into 43,590 shares of common stock | | \$ 3 |

See accompanying notes to consolidated financial statements.

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MERCURY AIR GROUP, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

YEARS ENDED JUNE 30, 2001, 2000 AND 1999

| | COMMON STOCK NUMBER OF SHARES | AMOUNT | ADDITIONAL PAID-IN CAPITAL | RETAINED EARNINGS | NOTE RECEIV OFFIC |
|---|-------------------------------------|-----------|----------------------------------|----------------------|-------------------------|
| | ----- | ----- | ----- | ----- | ----- |
| BALANCE, JUNE 30, 1998 | 7,082,753 | \$ 71,000 | \$ 20,465,000 | \$ 6,415,000 | \$ (662, |
| Net income | | | | 5,939,000 | |
| Repurchase of common stock | (641,781) | (6,000) | (1,865,000) | (2,811,000) | |
| Common stock issued on exercise of Options | 69,125 | | 144,000 | | |
| Common stock issued in acquisition | 124,224 | 1,000 | 999,000 | | |
| Common stock issued on conversion of debentures | 6,854 | | 50,000 | | |
| Tax benefit from exercises of stock options | | | 80,000 | | |

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| | | | | | |
|---|-----------|-----------|---------------|---------------|--------------|
| Foreign currency adjustment | | | | | |
| BALANCE, JUNE 30, 1999 | 6,641,175 | 66,000 | 19,873,000 | 9,543,000 | (662,000) |
| Net income | | | | 2,029,000 | |
| Repurchase of common stock | (234,375) | (2,000) | (705,000) | (1,149,000) | |
| Reduction of note receivable from sale of stock | | | | | 54,000 |
| Foreign currency adjustment | | | | | |
| Common stock issued on conversion of debentures | 43,590 | | 318,000 | | |
| Common stock issued in acquisition | 22,565 | | 158,000 | | |
| Warrants issued in connection with Senior Subordinated Note | | | 1,306,000 | | |
| Value of remeasured stock options | | | 64,000 | | |
| BALANCE, JUNE 30, 2000 | 6,472,955 | 64,000 | 21,014,000 | 10,423,000 | (608,000) |
| Net income | | | | 2,412,000 | |
| Common stock issued on exercise of options | 103,725 | 2,000 | 428,000 | | |
| Reduction of note receivable from sale of stock | | | | | 75,000 |
| BALANCE, JUNE 30, 2001 | 6,576,680 | \$ 66,000 | \$ 21,442,000 | \$ 12,835,000 | \$ (533,000) |

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MERCURY AIR GROUP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

THREE YEARS ENDED JUNE 30, 2001

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:

BUSINESS

Mercury Air Group, Inc., a Delaware corporation, provides a broad range of services to the aviation industry through four principal operating units: fuel sales and services, cargo operations, fixed base operations and U.S. government contract services. Fuel sales include the sale of fuel and delivery of fuel primarily to domestic and international commercial airlines, business aviation and air freight airlines. Cargo operations consist of cargo handling, space logistics operations and general cargo sales agent services. Fixed base operations ("FBOs") include fuel sales, into-plane services, ground support services, aircraft hangar and tie-down facilities and maintenance at certain

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locations for commercial, private, general aviation and military aircraft. Government contract services consist of aircraft refueling and fuel storage operations, base operating support (BOS) services, air terminal and ground handling services and weather observation and forecasting services performed principally for agencies of the United States government. Additionally, the Company had a fifth operating unit, RPA Airline Automation Services, Inc. ("RPA") which was sold on July 3, 2001 and is classified as a discontinued operation (see note 2).

MERCFUEL, INC.

On March 7, 2001, the Company announced its plan to create an independent publicly traded company, MercFuel, Inc. ("MercFuel"). MercFuel was organized in Delaware on October 27, 2000 as a wholly owned subsidiary of the Company. On January 1, 2001, the Company transferred to MercFuel, the assets and liabilities of its Fuel Sales division. On April 30, 2001, MercFuel agreed to sell 239,942 shares of common stock in a private placement at a per share price of \$4.35, the net proceeds of which were \$860,000. The sale will be consummated at such time as the Company's lenders consent to that offering. On May 15, 2001, the Company contributed \$4.0 million of equity to MercFuel in the form of cancellation of intercompany debt payable to the Company. On May 16, 2001, MercFuel filed a registration statement related to the proposed sale of 1,200,000 shares of common stock (excluding 180,000 shares to cover over-allotments and an option issued to the underwriter to purchase 120,000 shares, exercisable one year after the effective date of the offering at a price equal to 140% of the initial public offering price). There is no assurance the Company will complete the initial public offering, however, if the initial public offering is completed the Company will own at least 80.1% of MercFuel's outstanding common stock. The Company currently intends, subject to satisfactory resolution of certain conditions, to distribute (the "Distribution") all of the shares of MercFuel common stock that the Company owns to the Company's stockholders no earlier than six months after MercFuel's initial public offering.

PRINCIPLES OF CONSOLIDATION

The consolidated financial statements include the accounts of Mercury Air Group, Inc. and its subsidiaries. All material intercompany transactions and balances have been eliminated.

CASH AND CASH EQUIVALENTS

Cash equivalents consist of short-term, highly liquid investments that are readily convertible into cash and were purchased with maturities of three months or less.

INVENTORIES

Inventory is stated at the lower of aggregate cost (first-in, first-out method) or market.

PROPERTY, EQUIPMENT AND LEASEHOLDS

Property, equipment and leaseholds are recorded at cost. Depreciation is computed using the straight-line method over the estimated useful life of the related asset (3-25 years) and over the lesser of the lease term or useful life for leasehold improvements.

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COST IN EXCESS OF NET ASSETS ACQUIRED

Cost in excess of net assets acquired is being amortized using the straight-line method over the estimated lives ranging from ten to forty years. The Company assesses recoverability on a periodic basis. Factors included in evaluating recoverability include historical earnings and projected future earnings of the related operations.

FOREIGN CURRENCY TRANSLATION

Assets and liabilities of the Company's foreign subsidiaries are translated into U.S. dollars at the exchange rate prevailing at the balance sheet date and, where appropriate, at historical rates of exchange. Income and expense accounts are translated at the weighted average rate in effect during the year. The aggregate effect of translating the financial statements of the foreign subsidiary is included in other comprehensive income. Foreign exchange gains (losses) were not significant during the years presented.

REVENUE RECOGNITION

Revenues are recognized upon delivery of product or completion of service. The Company's contracts with the U.S. Government are subject to profit renegotiation. To date the Company has not been required to adjust profits arising out of U.S. Government contracts.

INCOME TAXES

Deferred income tax assets and liabilities are recognized based on differences between the financial statement and income tax basis of assets and liabilities using presently enacted income tax rates.

FAIR VALUE OF FINANCIAL INSTRUMENTS

The Company's financial instruments consist primarily of cash and cash equivalents, accounts receivable and payable, and debt instruments. The book values of all financial instruments, other than debt instruments, are representative of their fair values due to their short-term maturity. The book values of the Company's debt instruments are considered to approximate their fair values because the interest rates of these instruments are based on current rates offered to the Company or, in the case of publicly traded debt, based upon quoted market prices.

IMPAIRMENT OF LONG-LIVED ASSETS

The Company reviews for impairment of long-lived assets and certain identifiable intangibles whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. Measurement of an impairment loss is based on the estimated fair value of the asset.

USE OF ESTIMATES IN THE PREPARATION OF FINANCIAL STATEMENTS

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses for the reporting period. Actual results could differ from those estimates.

NEW ACCOUNTING PRONOUNCEMENTS

On July 1, 2000, the Company adopted Statement of Financial Accounting

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Standards ("SFAS") No. 133, "Accounting for Derivative Instruments and Hedging Activities" which establishes accounting and reporting standards for derivative instruments and for hedging activities. The statement requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value. There was no effect of adoption at July 1, 2000. At June 30, 2001, there were no outstanding derivative instruments.

In July 2001, the Financial Accounting Standards Board ("FASB") issued SFAS No. 141, "Business Combinations." SFAS No. 141 requires the purchase method of accounting for business combinations initiated after June 30, 2001 and eliminates the pooling-of-interest method.

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In July 2001, the FASB issued SFAS No. 142, "Goodwill and Other Intangible Assets." The Company is required to adopt SFAS No. 142 on July 1, 2002, however, the Company may elect to adopt SFAS 142 on July 1, 2001. SFAS No. 142 requires, among other things, the discontinuance of goodwill amortization. In addition, the standard includes provisions for the reclassification of certain existing recognized intangibles as goodwill, reassessment of the useful lives of existing recognized intangibles, reclassification of certain intangibles out of previously reported goodwill and the identification of reporting units for purposes of assessing potential future impairments of goodwill. SFAS. No. 142 also requires the Company to complete a transitional goodwill impairment test six months from the date of adoption. The Company has not yet determined what impact the adoption will have on its financial statements.

RECLASSIFICATIONS

Certain reclassifications were made to prior year statements to conform to the June 30, 2001 presentation.

RISKS AND UNCERTAINTIES

The events of September 11, 2001 have had a significant impact on the aviation industry and, as a result, has impacted the Company's operations as well. In the first few days following September 11, revenue from the Company's fuel sales, cargo and FBO operations were negligible. Since that time, the Company's operations have begun to return to normal. In view of the uncertainty of the ultimate impact upon the aviation industry, the long-term impact to the Company's operations cannot be determined at this time.

Accounts receivable is comprised primarily of trade receivables from customers and is net of an allowance for doubtful accounts. The Company's credit risk is based in part on the following: 1) substantially all receivables are related to a single industry, aviation, 2) there is a concentration of credit risk as there are several customers who at any time have significant balances owed to the Company, and 3) significant balances are owed by certain customers that are not adequately capitalized. In addition, significantly higher fuel prices for extended periods of time have a negative impact on the aviation industry as it substantially increases airlines' operating expenses. Smaller airlines with lower levels of capital may be more seriously impacted. During the year ended June 30, 2001, per gallon fuel cost increased by approximately 21%. The Company assesses its credit portfolio on an ongoing basis and establishes allowances which it believes are adequate to absorb potential credit problems that can be reasonably anticipated.

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The Company purchases fuel from a limited number of suppliers. If the Company's relationship with any of these key suppliers terminates, the Company may not be able to obtain a sufficient quantity of fuel on favorable terms or may experience difficulty in obtaining fuel from alternative suppliers. Furthermore, difficulties faced by these suppliers or fuel shortages or the inability to obtain fuel from alternate sources at acceptable prices and terms, could impair the Company's ability to sell fuel to its customers at competitive prices and terms.

NOTE 2 - DISCONTINUED OPERATIONS

On July 3, 2001, the Company completed the sale of its subsidiary, RPA Airline Automation Services, Inc. ("RPA"), which provides airline revenue accounting and management information software consisting of proprietary software programs which are marketed to foreign and domestic airlines. The Company has reclassified its consolidated financial statements to reflect the sale of RPA and to segregate the revenues, direct costs and expenses (excluding allocated costs), assets and liabilities, and cash flows of RPA. The net operating results, net assets and net cash flows of this business have been reported as "Discontinued Operations" in the accompanying consolidated financial statements.

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Pursuant to the agreement to which the sale was made, the Company received a cash purchase price of \$3.6 million. The Company realized a loss on the sale of \$477,000 (net of an income tax benefit of \$305,000). Summarized financial information for the discontinued operations is as follows:

| | FISCAL YEAR ENDED JUNE 30, | |
|-----------------------------------|----------------------------|--------------|
| | 2001 (1) | 2000 |
| Service revenues | \$ 4,224,000 | \$ 4,409,000 |
| Operating expense | 4,334,000 | 5,710,000 |
| Gross (loss) margin | (110,000) | (1,301,000) |
| Other Expense | 1,296,000 | 229,000 |
| (Loss) Income before income taxes | (1,406,000) | (1,530,000) |
| Income tax (benefit) charge | (548,000) | (597,000) |
| Net (loss) income | \$ (858,000) | \$ (933,000) |

JUNE 30

| 2001 | 2000 |
|------|------|
|------|------|

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| | | |
|---------------------------------------|-------------|-------------|
| Current Assets | \$4,324,000 | \$4,887,000 |
| Total Assets | 5,292,000 | 6,732,000 |
| Current and Total Liabilities | 954,000 | 661,000 |
| | | |
| Net assets of discontinued operations | 4,338,000 | 6,071,000 |

The Company retained certain assets and liabilities owned by RPA, principally land and building with a net carrying value of \$697,000. The Company has listed the land and building for sale and expects the net proceeds from the sale to approximate the carrying value.

NOTE 3 - PROPERTY, EQUIPMENT AND LEASEHOLDS:

Property, equipment and leaseholds consist of the following:

| | JUNE, 30 | |
|--|---------------|---------------|
| | 2001 | 2000 |
| Land, buildings and leasehold improvements | \$ 86,691,000 | \$ 73,000,000 |
| Equipment, furniture and fixtures | 32,096,000 | 30,000,000 |
| Construction in progress | 5,157,000 | 3,000,000 |
| | ----- | ----- |
| | 123,944,000 | 107,000,000 |
| | | |
| Less accumulated depreciation and amortization | (52,165,000) | (43,000,000) |
| | ----- | ----- |
| | \$ 71,779,000 | \$ 63,000,000 |
| | ===== | ===== |

NOTE 4 - OTHER ASSETS:

Other assets consists of the following:

| | JUNE, 30 | |
|---|--------------|--------------|
| | 2001 | 2000 |
| Cost in excess of net assets acquired - net | \$ 5,191,000 | \$ 5,632,000 |
| Capitalized loan fees - net (Note 7) | 2,233,000 | 2,393,000 |
| Covenants not to compete - net | 383,000 | 583,000 |
| Other | 1,333,000 | 2,982,000 |
| | ----- | ----- |
| | \$ 9,140,000 | \$11,590,000 |
| | ===== | ===== |

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Cost in excess of net assets acquired and covenants not to compete have resulted from various acquisitions and are being amortized using the straight-line method over periods ranging from five to forty years. Accumulated amortization related to cost in excess of net assets acquired was \$1,460,000 and \$1,485,000 at June 30, 2001 and 2000, respectively. Accumulated amortization related to covenants not to compete was \$617,000 and \$417,000 at June 30, 2001 and 2000, respectively.

Capitalized loan fees represent cost incurred in connection with outstanding debt and are being amortized over the term of the debt.

In 1994, an executive officer of the Company purchased 151,250 shares of the Company's stock from a company owned by the then Chairman at \$1.98 per share, pursuant to a Stock Purchase Agreement. The officer paid \$30,000 in cash and the remaining purchase price of \$270,000 was paid over a five year period ending in 1998. As part of the agreement, the Company loaned the executive the \$270,000. Beginning in 1996, one fifth of the amount loaned, or \$54,000, was forgiven annually through the year ended June 30, 2000. The amount subject to forgiveness of \$270,000 was treated as additional compensation expense over the seven-year period from the date of the agreements through 2000.

NOTE 5 - ACCRUED EXPENSES AND OTHER CURRENT LIABILITIES:

Accrued expenses and other current liabilities consist of the following:

| | JUNE, 30 | |
|--------------------|--------------|--------------|
| | 2001 | 2000 |
| Salaries and wages | \$ 2,977,000 | \$ 3,077,000 |
| Other | 7,380,000 | 2,624,000 |
| | \$10,357,000 | \$ 5,701,000 |
| | ===== | ===== |

NOTE 6 - INCOME TAXES:

The provision for taxes on income consists of the following:

| | YEAR ENDED JUNE 30, | | |
|-----------------------------|---------------------|--------------|--------------|
| | 2001 | 2000 | 1999 |
| Federal, current | \$ 1,855,000 | \$ 2,235,000 | \$ 3,134,000 |
| State, current | 272,000 | 398,000 | 693,000 |
| | 2,127,000 | 2,633,000 | 3,827,000 |
| Deferred, primarily federal | 270,000 | (113,000) | 27,000 |
| | 2,397,000 | 2,520,000 | 3,854,000 |
| Discontinued operations | (853,000) | (597,000) | 251,000 |
| Extraordinary item | -- | (625,000) | (309,000) |
| | ===== | ===== | ===== |

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| | | | |
|---------------|-----------------------|-----------------------|-----------------------|
| Net Provision | \$ 1,544,000 ===== | \$ 1,298,000 ===== | \$ 3,796,000 ===== |
|---------------|-----------------------|-----------------------|-----------------------|

Major components of deferred income tax (assets) and liabilities were as follows:

| | JUNE 30, | |
|---|------------|------------|
| | 2001 | 2000 |
| Depreciation/amortization | \$ 909,000 | \$ 683,000 |
| Prepaid expenses | 695,000 | 322,000 |
| State income taxes | (90,000) | (222,000) |
| Allowance for doubtful accounts | (645,000) | (888,000) |
| Capital loss | (642,000) | (276,000) |
| Cash to accrual basis conversion as a result of previous acquisition | -- | 329,000 |
| Other | 153,000 | 162,000 |
| | ----- | ----- |
| | \$ 380,000 | \$ 110,000 |
| | ===== | ===== |

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The reconciliation of the federal statutory rate to the Company's effective tax rate on income is summarized as follows:

| | YEAR ENDED JUNE 30, | | |
|--|---------------------|-------|-------|
| | 2001 | 2000 | 1999 |
| Computed "expected" tax rate | 34.0% | 34.0% | 34.0% |
| State income taxes, net of Federal income tax benefit | 5.0% | 5.0% | 5.0% |
| | ----- | ----- | ----- |
| Effective rate | 39.0% | 39.0% | 39.0% |
| | ===== | ===== | ===== |

NOTE 7 - LONG-TERM:

Long-term debt consists of the following:

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Notes payable to banks

Tax exempt bond pursuant to a loan agreement between the Company and the California Economic Development Financing Authority ("CEDFA"). Repayment terms consist of semi-annual principal payments of \$500,000 with a redemption of \$4 million at the end of the fifteenth year (2013). The loan carries a variable rate which is based on a weekly remarketing of the bonds. The rate at June 30, 2001 was 2.6%. In addition, a letter of credit has been issued by the Company's Senior lender to guaranty the credit at an annual cost of approximately 1.9% of the principal

Notes payable to trustees for bankrupt airlines

Mortgages payable to financial institution in aggregate monthly principal installments of \$14,197 plus interest at 7.5% to 9% per annum, collateralized by land and buildings, maturing in April 2004 through May 2010

Convertible subordinated debentures payable to seller of Excel Cargo in monthly installments of \$13,810 including interest at 8.5%, collateralized by property acquired, maturing in September 2003

Other

Less current portion

Notes Payable to banks consists principally of a credit facility (the "Credit Facility") which provides for a term loan (the "Term Loan"), an acquisition line (the "Acquisition Line") and a revolving line of credit ("the Revolver"). The Credit Facility expires in March 2004. Borrowings under the Term Loan were \$15.3 million and \$19.9 million at June 30 2001 and 2000, respectively. Principal payments are payable in quarterly installments of \$1.3 million as of June 30, 2001, increasing \$125,000 annually. The Acquisition Line permits borrowings of up to \$18.5 million. Outstanding borrowings under the Acquisition Line were \$18.1 million and \$9.9 million at June 30, 2001 and 2000, respectively. Principal is due in March 2004. The Revolver permits borrowings of up to \$35.0 million. There were no outstanding borrowings under the Revolver at both June 30, 2001 and 2000. Interest under the credit facility accrues at LIBOR+2.50% (6.25% based on 30 day LIBOR rates in effect at June 30, 2001).

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Certain debt agreements contain provisions that require the maintenance of certain financial ratios, minimum tangible net worth (as defined), minimum profitability levels, maximum leverage and minimum debt service coverage and quick ratios and limitations on annual capital expenditures. Additionally, the Company is prohibited from paying dividends in excess of \$400,000 per fiscal year. At June 30, 2001, the Company received a waiver from its senior lender as it had violated its quarterly profitability covenant.

Notes payable to trustees for bankrupt airlines results from settlements with two bankrupt airlines. On March 16, 2001, the bankruptcy court approved a settlement related to preference payments received in connection with the Chapter 7 bankruptcy filing of Western Pacific Airlines, Inc. ("WPAI"). The settlement consists of ten quarterly payment of \$175,000, two of which were made

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in the current fiscal year with the unpaid balance secured by a letter of credit. The Company has recorded a charge to bad debt expense equal to the present value of the payments, \$1.6 million. The outstanding balance was \$1.3 million at June 30, 2001. In February 2001, the Company received notice of a complaint filed by the Chapter 7 Trustee for Tower Airlines in regard to a preference action. In July 2001, the Company settled this matter for \$1.0 million. In accordance with the terms of the settlement, the Company paid \$750,000 subsequent to June 30, 2001 and will pay the balance in ten monthly installments of \$25,000 each. At June 30 2001, the unpaid settlement balance of \$750,000 is included in accrued expenses and the unpaid note balance of \$250,000 is included in notes payable. The note is secured by a letter of credit.

Long-term debt payable subsequent to June 30, 2001 is as follows:

| | |
|------------|--------------|
| 2002 | \$ 7,461,000 |
| 2003 | 7,455,000 |
| 2004 | 23,853,000 |
| 2005 | 1,026,000 |
| 2006 | 1,026,000 |
| Thereafter | 11,200,000 |
| | ----- |
| | \$52,021,000 |
| | ===== |

NOTE 8 - SENIOR SUBORDINATED NOTES/EXTRAORDINARY ITEM:

On September 10, 1999, the Company issued, in a private placement, \$24.0 million Senior Subordinated 12% Notes ("the Note") due 2006 with detachable warrants to acquire 503,126 shares of the Company's common stock exercisable at \$6.50 per share for seven years. The Note agreement contains covenants that, among other matters, limit senior indebtedness, the disposition of assets and unfunded capital expenditures. The covenants also include ratio tests for interest coverage, leverage, fixed charge coverage and debt service. The Company received a waiver from the note holder as of June 30, 2001 for covenant violations pertaining to interest coverage.

Proceeds of the Note were used to redeem the remaining \$19.5 million of the Company's 7 3/4% convertible subordinated debentures due February 1, 2006 at 104% of the principal amount plus accrued interest and pay expenses of the transaction as follows:

| | |
|--|-----------|
| Principal balance of Debentures redeemed | \$ 19,509 |
| Redemption premium of 4% | 780 |
| Accrued Interest | 164 |
| Placement fees, legal fees and other expenses of transaction capitalized as other assets | 1,750 |
| Cash received | 1,797 |
| | ----- |
| Proceeds | \$ 24,000 |
| Valuation of warrants credited to additional paid-in-capital | (1,306) |
| Warrants amortized as interest expense through June 30, 2001 | 336 |
| | ----- |
| Senior Subordinated Note | \$ 23,030 |
| | ===== |

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As a result of this transaction the Company recorded an extraordinary charge of \$979,000 in fiscal 2000 (net of a \$625,000 income tax benefit). The extraordinary charge consists of the redemption premium of \$780,000 plus the write off of capitalized fees of \$824,000.

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During the year ended June 30, 1999 the Company repurchased debentures in the open market. The excess of cost over par value plus bond issuance costs was \$675,000. In addition, during fiscal 1999 the Company terminated its prior credit facility resulting in the write off of related deferred financing costs of \$117,000. The aggregate charge of \$792,000, net of tax benefits of \$309,000, has been classified as an extraordinary item.

NOTE 9 - EMPLOYEE STOCK OPTION PLANS:

The Company has the following stock option plans, the 1990 Long-Term Incentive Plan ("1990 Incentive Plan"), the 1990 Directors Stock Option Plan ("1990 Directors Plan"), the 1998 Long-Term Incentive Plan ("1998 Incentive Plan") and the 1998 Directors Stock Option Plan ("1998 Directors Plan"). The Company has reserved 837,000 shares related to the Incentive Plans and 587,000 shares related to the Directors Plans. The Company has also reserved 7,000 shares for special option grants made outside the plans. Options granted pursuant to the plans and special grants are generally made at the fair market value of such shares on the date of grant and generally vest over twelve months. The contractual lives of the options are generally ten years.

The Company accounts for stock options in accordance with Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees." Had compensation cost for stock options been calculated using the fair value provisions of Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation," the Company's net income and earnings per share would have approximated the pro forma amounts indicated in the following table:

| | 2001 ----- | 2000 ----- | 1999 ----- |
|--|---------------|---------------|---------------|
| Net income - as reported | \$2,412,000 | \$2,029,000 | \$5,939,000 |
| Net income - pro forma | 2,209,000 | 1,877,000 | 5,840,000 |
| Basic earnings per share - as reported | .37 | .31 | .89 |
| Basic earnings per share - proforma | .34 | .29 | .88 |
| Diluted earnings per share - as reported | .36 | .30 | .68 |
| Diluted earnings per share - pro forma | .33 | .27 | .67 |

The weighted average fair value of options granted in 2001, 2000 and 1999 is estimated as \$2.60, \$3.45 and \$3.00 respectively, on the date of grant using the Black-Scholes option pricing model using the following weighted average assumptions.

| | 2001 ----- | 2000 ----- | 1999 ----- |
|-------------------------|---------------|---------------|---------------|
| Expected life | 5 years | 5 years | 5 years |
| Expected volatility | 43% | 38% | 34% |
| Risk free interest rate | 4.90% | 6.19% | 5.78% |

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Dividend yield 0% 0% 0%

A summary of stock option activity is as follows:

| | WEIGHTED AVERAGE OPTION PRICES | LONG-TERM INCENTIVE PLANS | WEIGHTED AVERAGE OPTION PRICES | DIRECTOR'S STOCK OPTION PLANS | WEIGHTED AVERAGE OPTION PRICES |
|---------------|--------------------------------------|---------------------------------|--------------------------------------|-------------------------------------|--------------------------------------|
| Outstanding | | | | | |
| June 30, 1998 | \$4.03 | 262,897 | \$4.53 | 317,625 | \$ |
| Granted | 7.56 | 138,361 | -- | -- | |
| Exercised | 3.78 | (17,125) | -- | -- | 1 |
| Cancelled | 6.30 | (14,000) | -- | | |
| Outstanding | | | | | |
| June 30, 1999 | 5.25 | 370,133 | 4.53 | 317,625 | |
| Granted | 8.125 | 65,300 | 7.75 | 40,000 | |
| Exercised | -- | -- | -- | -- | |
| Cancelled | 7.87 | (20,303) | -- | | |
| Outstanding | | | | | |
| June 30, 2000 | 5.60 | 415,130 | 4.89 | 357,625 | |
| Granted | 6.125 | 46,400 | 5.73 | 90,000 | |
| Exercised | | | 5.36 | (45,375) | |
| Repurchased | | | | | 1 |
| Cancelled | 7.60 | (13,000) | 7.13 | (35,125) | |
| Outstanding | | | | | |
| June 30, 2001 | \$5.59 | 448,530 | \$4.82 | 367,125 | \$ |

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A summary of information about stock options issued and outstanding pursuant to the Incentive Plan, Directors Plan and special option grants at June 30, 2001 is as follows:

| EXERCISE PRICE RANGE | OPTIONS OUTSTANDING | | OPTIONS EXERCISABLE | | WEIGHTED AVERAGE EXERCISE PRICE |
|-------------------------|-------------------------------------|---|--|-------------------------------------|--|
| | SHARES OUTSTANDING AT 6/30/01 | WEIGHTED AVERAGE CONTRACTUAL REMAINING LIFE | WEIGHTED AVERAGE EXERCISE PRICE | SHARES EXERCISABLE AT 6/30/01 | |
| \$1.236 - 2.436 | 218,397 | 1.4 | \$1.70 | 218,397 | \$1.70 |
| 3.669 - 5.750 | 236,375 | 6.7 | 5.55 | 156,375 | 5.50 |
| 6.090 - 7.182 | 209,958 | 6.2 | 6.49 | 147,539 | 6.63 |
| 7.75 - 8.4375 | 157,800 | 8.1 | 8.13 | 157,800 | 8.13 |
| | 822,530 | | \$5.26 | 680,111 | \$5.14 |

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In March 2000, the Board of Directors extended the termination date of options for 38,875 shares held by an officer and a Director. This resulted in compensation expense of \$64,000.

During fiscal 1996, the Company sold 137,500 shares of its common stock to two officers for \$812,500. The officers each paid \$40,000 in cash and issued promissory notes of \$732,500 for the balance of the purchase price. The notes are payable over ten years and due in fiscal year 2006. As of June 30, 2001, \$533,000 remained outstanding.

NOTE 10 - ACQUISITIONS:

The Company has acquired various businesses during the years reported. All such acquisitions have been accounted for under the purchase method of accounting. Pro forma disclosure has not been provided as the aggregate annual purchases have not been material. The following describes the various purchases.

Fiscal 2001

On September 1, 2000, the Company acquired the assets of an FBO in Birmingham, Alabama from Raytheon Aircraft Services, Inc. ("RAS") for \$6.6 million in cash funded under the Company's acquisition line. The acquisition was accounted for under the purchase method of accounting. The purchase price was allocated principally to Property, Equipment and Leaseholds. At June 30, 2000, Other Assets included a \$1.5 million cash deposit paid to RAS towards the purchase price.

In July 2000, the Company purchased hangers, buildings and leaseholds at its Tulsa, Oklahoma FBO and paid \$3.8 million cash which was borrowed from its acquisition line.

Fiscal 2000

On April 21, 2000, the Company acquired certain assets of an FBO located in Fort Wayne, Indiana ("FWAS") for \$3,900,000 in cash. The Company utilized borrowing available under its acquisition line to fund the purchase. The purchase price was allocated primarily to Property, Equipment and Leaseholds with an amount also allocated to inventories.

On October 22, 1999, the Company acquired certain assets of Air Tulsa, Inc., an FBO located in Tulsa, Oklahoma. Assets acquired included refueling equipment and tank farms utilized in the FBO business, as well as inventories, prepaid expenses and a sublease. The agreement also includes a non-compete with the seller. Total consideration was \$2.4 million which the Company initially paid in cash and which was subsequently funded by borrowings available under its acquisition line. The agreement included a second closing to occur within eighteen months to include the purchase of hangars, buildings and the leasehold for additional cash consideration of \$3.8 million. This transaction was completed in July 2000. The Company utilized borrowing under its acquisition line to fund this amount.

On October 5, 1999, the Company acquired certain FBO assets of Charleston Equities, Inc. for \$700,000 in cash. The purchase consolidated the leasehold at Charleston International Airport and includes the leasehold at John's Island Executive Airport.

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Fiscal 1999

Effective November 30, 1998 the Company acquired substantially all the

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assets of Jackson Air Center in Mississippi for \$4,500,000 in cash. The Company borrowed \$2.8 million in term debt under its senior credit facility and the balance was funded from borrowings under its revolver. The purchase price has been allocated primarily to Property, Equipment and Leaseholds (\$4,195,000) with the balance to inventories and accounts payable.

On August 1, 1998, the Company acquired the weather observation and forecasting and air traffic control government contracts and related assets of Weather Data Services, Inc. for \$3.5 million, which consisted of \$2.5 million in cash and \$1.0 million of the Company's stock. The purchase price has been allocated to intangible assets. During fiscal 2000, as part of the agreement, the Company issued an additional 22,565 shares of the Company's stock valued at \$158,000.

NOTE 11- COMMITMENTS AND CONTINGENCIES:

PROPOSED DISTRIBUTION OF MERCFUEL

The Company believes, based in part on an opinion of its tax advisors, that although the matter is not free from doubt, the contribution by the Company of certain assets and liabilities to MercFuel in exchange for common stock of MercFuel, which is to be followed by the proposed Distribution, should be treated as a reorganization within the meaning of Section 368(a)(1)(D) of the Internal Revenue Code of 1986 (the "Code"), as amended, and the Distribution should qualify as a tax-free distribution under Section 355 of the Code. It should be noted that the application of Section 355 of the Code to the Distribution is complex and may be subject to differing interpretation. If the Distribution does not qualify as a tax-free distribution under Section 355 of the Code, then: (i) the Company would recognize capital gain equal to the difference between the fair market value of the MercFuel common stock on the date of the Distribution and the Company's tax basis; and (ii) the Distribution may be taxable to individual stockholders, depending on their individual tax basis.

For purposes of governing certain of the ongoing relationships subsequent to the proposed Distribution, the Company and MercFuel intend to enter into a Master Distribution Agreement, along with key related agreements, which will be effective as of the closing date of the initial public offering of the MercFuel common stock (except for a transitional services agreement, which will be effective at the time of the Distribution).

LEASES

The Company is obligated under noncancellable operating leases. Certain leases include renewal clauses and require payment of real estate taxes, insurance and other operating costs. Total rental expense on all such leases for the fiscal years 2001, 2000 and 1999 was \$10,133,000, \$8,640,000 and \$8,037,000, respectively, which is net of sublease income of approximately \$332,000 annually. The minimum annual rentals on all noncancellable operating leases having a term of more than one year at June 30, 2001 are as follows:

| | |
|--------------------------------|---------------|
| 2002 | \$ 10,096,000 |
| 2003 | 9,995,000 |
| 2004 | 9,926,000 |
| 2005 | 9,485,000 |
| 2006 | 8,933,000 |
| Thereafter | 59,386,000 |
| | ----- |
| Total minimum payment required | \$107,821,000 |
| | ===== |

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PURCHASE COMMITMENTS

On June 1, 2001, the Company's cargo unit entered into a one-year renewal of its contract to purchase all of South African Airlines cargo capacity on its passenger flights from the United States and Canada to South Africa. MAC's one-year commitment for these routes is approximately \$6.2 million.

On August 10, 2001, the MercFuel entered into an agreement with a provider of hardware and software applications ("System Provider"), for the development and exclusive license of an aviation fuel management system. The agreement requires MercFuel to pay the System Provider \$25,000 by October 1, 2001, and enter into a non-interest bearing note in the amount of \$750,000, payable in 24 equal monthly payments beginning in August 2002 (the present value of which is \$640,000, assuming an imputed interest rate of

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8%). The note is convertible, at MercFuel's option, at any time after the Distribution into 125,000 shares of MercFuel common stock. MercFuel is also required to attempt to register the shares. In addition, if MercFuel does not complete an offering of its common shares by December 31, 2001, the agreement shall be terminated.

LITIGATION

On March 16, 2001, the bankruptcy court approved a settlement related to preference payments received in connection with the Chapter 7 bankruptcy filing of Western Pacific Airlines, Inc ("WPAI"). The settlement consists of ten quarterly payments of \$175,000, two of which were made in the current fiscal year with the unpaid balance secured by a letter of credit. The Company has recorded a charge to bad debt expense equal to the present value of the payments, \$1.6 million. The outstanding balance of \$1.3 million at June 30, 2001 was included in current and long-term debt.

In November 1999, Mr. Perez, formerly the President of RPA, filed a lawsuit alleging violations of his employment contract between the Company, RPA and Mr. Perez asserting, among other things, constructive termination. During the quarter ended March 31, 2001, this suit was dismissed.

In February 2001, the Company received notice of a complaint filed by the Chapter 7 Trustee for Tower Air in regard to a preference action. In July 2001, the Company settled this matter for \$1.0 million. In accordance with the terms of the settlement, the Company paid \$750,000 subsequent to June 30, 2001 and will pay the balance in ten monthly installments of \$25,000 each. At June 30, 2001, the unpaid settlement balance of \$750,000 is included in accrued expenses and the unpaid note balance of \$250,000, which is secured by a letter of credit, is included in the current portion of long-term debt.

In April 2000, Mercury filed a collection action against AER Global Logistics ("AER") in the state of New York. AER filed a counterclaim for \$1.0 million alleging among other things, tortious interference with contract. Mercury believes that this claim is without merit, and accordingly, does not believe this matter will have a significant impact on its financial position or operating results.

On April 3, 2001 Mercury received notice of an action filed by Skylink Express, Inc. in the Superior Court of Justice Ontario, Canada against Excel Cargo, Inc. and others for damages to aircraft occurring in November 30, 1999 and January 10, 2000 at Mirabel International Airport Quebec for a total amount

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of \$2.5 million Canadian (\$1.65 million U.S.) plus interest and fees. Mercury does not believe the outcome of this claim will have a significant impact on its financial position or operating results.

The Company is also a defendant in certain litigation arising in the normal course of business. In the opinion of management, the ultimate resolution of such litigation will not have a significant effect on the financial statements.

RELATED PARTY TRANSACTION

The Company and its Chairman each own a 50% interest in an LLC that owns and operates a corporate airplane. The Company contributed capital to the LLC of \$137,000 each in fiscal 2001 and fiscal 2000. Amounts paid to the LLC by the Company for the use of the airplane were insignificant in both years. The Company is a guarantor on a note payable to a financial institution which funded the purchase of the aircraft. The principal balance of the note as of June 30, 2001 was \$1.0 million.

The Company paid \$317,000, during fiscal 2001 to McBreen & Kopko related to legal services. Frederick H. Kopko, Jr., a partner of McBreen & Kopko, is a member of the Company's board of directors. In addition, Mr. Kopko is a partner in CFK partners, the Company's largest shareholder.

NOTE 12 - MAJOR CUSTOMERS AND FOREIGN CUSTOMERS:

National Airlines, Inc. represented approximately 14% and 11% of consolidated revenue for fiscal 2001 and 2000, respectively and AirTran Airways represented approximately 14% of consolidated revenue for fiscal 2001. Government contract services consists of revenues from agencies of the United States government. Revenue from this segment represented 6.0%, 7.6% and 11.7% of the Company's consolidated revenues for fiscal 2001, 2000 and 1999, respectively. No other customers accounted for over 10% of Mercury's consolidated revenues.

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The Company does business with a number of foreign airlines, principally in the sale of aviation fuels. For the most part, such sales are made within the United States and utilize the same assets and generally the same personnel as are utilized in the Company's domestic business. Revenues related to these foreign airlines amounted to approximately 18%, 25% and 29% of consolidated revenues for the years ended June 30, 2001, 2000 and 1999, respectively.

NOTE 13 - EARNINGS PER SHARE:

Basic earnings per common share is computed by dividing net income by the weighted average number of common shares outstanding during the period.

Diluted earnings per share is computed by dividing net income by the weighted average number of common shares and dilutive common stock equivalents. Common stock equivalents include stock options and shares resulting from the assumed conversion of subordinated debentures, when dilutive.

| FISCAL YEAR JUNE 30, 2001 | | FISCAL YEAR JUNE 30, 2000 | |
|------------------------------|-------|------------------------------|-------|
| DILUTED | BASIC | DILUTED | BASIC |
| | | | |

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| | | | | |
|--|--------------|--------------|--------------|--------------|
| Weighted average number of common shares outstanding during the period | 6,531,000 | 6,531,000 | 6,565,000 | 6,565,000 |
| Common stock equivalents resulting from the assumed exercise of stock options | 176,000 | | 344,000 | |
| Common shares resulting from the assumed conversion of debentures | 40,000 | | 590,000 | |
| ----- | | | | |
| Weighted average number of common and common equivalent shares outstanding during the period | 6,747,000 | 6,531,000 | 7,499,000 | 6,565,000 |
| ----- | | | | |
| Net income from continuing operations before extraordinary item | \$ 3,747,000 | \$ 3,747,000 | \$ 3,941,000 | \$ 3,941,000 |
| Add: Interest expense, net of tax, on convertible debentures | 20,000 | | 185,000 | |
| ----- | | | | |
| Adjusted income from continuing operations | 3,767,000 | 3,747,000 | 4,126,000 | 3,941,000 |
| Discontinued Operations: | | | | |
| (Loss) Income from discontinued operations | (858,000) | (858,000) | (933,000) | (933,000) |
| Loss on sale of discontinued operations | (477,000) | (477,000) | | |
| Extraordinary item | | | (979,000) | (979,000) |
| ----- | | | | |
| Adjusted net income | \$ 2,432,000 | \$ 2,412,000 | 2,214,000 | \$ 2,029,000 |
| Common stock and common share equivalents | 6,747,000 | 6,531,000 | 7,499,000 | 6,565,000 |
| Earnings (Loss) per share: | | | | |
| From continuing operations | \$ 0.56 | \$ 0.57 | \$ 0.55 | \$ 0.60 |
| (Loss) Income from discontinued operations | (0.13) | (0.13) | (0.12) | (0.14) |
| Loss on sale of discontinued operations | (0.07) | (0.07) | | |
| ----- | | | | |
| Income (Loss) before extraordinary item | 0.36 | 0.37 | 0.43 | 0.46 |
| Extraordinary Item | | | (0.13) | (0.15) |
| ----- | | | | |
| Net Income | \$ 0.36 | \$ 0.37 | \$ 0.30 | \$ 0.31 |
| ----- | | | | |

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NOTE 14 - QUARTERLY FINANCIAL DATA (UNAUDITED):

| | 2001 | |
|--------------------|--------------------------------|-------------------------------|
| | ----- SEPTEMBER 30 ----- | ----- DECEMBER 31 ----- |
| Sales and Revenues | \$111,395,000 | \$134,094,000 |

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| | | |
|-----------------------------------|-----------|------------|
| Gross Margin | 9,026,000 | 10,450,000 |
| Income from continuing operations | 1,107,000 | 1,705,000 |
| Net Income (Loss) | 1,156,000 | 1,782,000 |

Net Income Per Share:

Basic:

| | | |
|--|---------|---------|
| From continuing operations | \$ 0.17 | \$ 0.26 |
| (Loss) Income from discontinued operations | 0.01 | 0.01 |
| Loss on sale of discontinued operations | -- | -- |
| | ----- | ----- |
| Income (Loss) before extraordinary item | 0.18 | 0.27 |
| Extraordinary item | -- | -- |
| | ----- | ----- |
| Net income (Loss) | \$ 0.18 | \$ 0.27 |

Diluted:

| | | |
|--|---------|---------|
| From continuing operations | \$ 0.16 | \$ 0.25 |
| (Loss) Income from discontinued operations | 0.01 | 0.02 |
| Loss on sale of discontinued operations | -- | -- |
| | ----- | ----- |
| Income (Loss) before extraordinary item | 0.17 | 0.27 |
| Extraordinary item | -- | -- |
| | ----- | ----- |
| Net income (Loss) | \$ 0.17 | \$ 0.27 |

2000

| | SEPTEMBER 30 | DECEMBER 31 | MARCH 31 |
|---|---------------|---------------|---------------|
| | ----- | ----- | ----- |
| Sales and Revenues | \$ 73,517,000 | \$ 82,715,000 | \$ 88,923,000 |
| Gross Margin | 9,374,000 | 9,368,000 | 7,704,000 |
| Income from Continuing Operations | 2,227,000 | 1,911,000 | (981,000) |
| Net Income (Loss) | 1,089,000 | 1,493,000 | (1,282,000) |
| Net Income per Share: | | | |
| Basic: | | | |
| From continuing operations | \$ 0.33 | \$ 0.29 | \$ (0.09) |
| Loss from discontinued operations | (0.02) | (0.06) | (0.02) |
| Loss on sale on discontinued operations | -- | -- | -- |
| | ----- | ----- | ----- |
| Income (Loss) before extraordinary item | 0.31 | 0.22 | (0.11) |
| Extraordinary item | (0.15) | -- | -- |
| | ----- | ----- | ----- |
| Net Income (Loss) | \$ 0.16 | \$ 0.22 | \$ (0.11) |
| Diluted: | | | |
| From continuing operations | \$ 0.26 | \$ 0.26 | \$ (0.09) |
| Loss from discontinued operations | (0.02) | (0.05) | (0.02) |
| Loss on sale of discontinued operations | -- | -- | -- |
| | ----- | ----- | ----- |
| Income (Loss) before extraordinary item | 0.25 | 0.21 | (0.11) |
| Extraordinary item | (0.11) | -- | -- |
| | ----- | ----- | ----- |
| Net income (Loss) | \$ 0.14 | \$ 0.21 | \$ (0.11) |

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NOTE 15 - SEGMENT REPORTING:

The Company operates and reports its activities through four principal units: 1) Fuel Sales, 2) Fixed Based Operations, 3) Cargo Operations and 4) Government contract services. Additionally, the Company had a fifth operating unit, RPA, which was sold on July 3, 2001 and shown as a discontinued operation. As a result, RPA's historical operating results have been reclassified as a discontinued operations. The segment data included below has been restated to exclude amounts related to the RPA business unit.

| (DOLLARS IN THOUSANDS) | FUEL SALES | FIXED BASE OPERATIONS | CARGO OPERATIONS | GOVERNMENT CONTRACT SERVICES | CORPORATE OR UNALLOCATED |
|-------------------------------|---------------|--------------------------|---------------------|------------------------------------|--------------------------------|
| 2001 | | | | | |
| Revenues | \$318,857 | \$99,482 | \$31,337 | \$28,770 | |
| Gross Margin | 7,493 | 15,012 | 6,766 | 5,671 | |
| Depreciation and Amortization | 62 | 5,389 | 3,040 | 841 | \$ 676 |
| Capital expenditures | 14 | 4,462 | 1,884 | 77 | 34 |
| Segment Assets | 35,608 | 69,779 | 17,642 | 11,907 | 11,860 |
| 2000 | | | | | |
| Revenues | \$202,906 | \$73,666 | \$32,474 | \$25,287 | |
| Gross Margin | 7,884 | 11,522 | 9,977 | 5,031 | |
| Depreciation and Amortization | 58 | 4,292 | 3,262 | 827 | \$ 723 |
| Capital expenditures | 92 | 8,796 | 756 | 965 | 17 |
| Segment Assets | 28,421 | 31,248 | 31,616 | 19,391 | 17,707 |
| 1999 | | | | | |
| Revenues | \$111,296 | \$53,799 | \$27,741 | \$25,436 | |
| Gross Margin | 8,892 | 11,280 | 5,751 | 5,297 | |
| Depreciation and Amortization | 57 | 3,282 | 3,649 | 827 | \$ 482 |
| Capital expenditures | 687 | 12,940 | 551 | 497 | 399 |
| Segment Assets | 30,408 | 21,485 | 24,293 | 16,780 | 27,025 |

Gross margin is used as the measure of profit and loss for segment reporting purposes as it viewed by key decision makers as the principal operating indicator in measuring segment profitability. The key decision makers also view bad debt expense as an important measure of profit and loss. The predominant component of bad debt expense relates to Fuel Sales. Bad debt expense for Fuel Sales was approximately \$3,025,000, \$5,000,000 and \$1,377,000; total bad debt expense was \$3,425,000, \$5,408,000 and \$1,721,000 in fiscal 2001, fiscal 2000 and fiscal 1999, respectively.

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MERCURY AIR GROUP, INC. AND SUBSIDIARIES
 SCHEDULE II - VALUATION AND QUALIFYING ACCOUNTS
 THREE YEARS ENDED JUNE 30, 2001

| CLASSIFICATION | BALANCE AT BEGINNING OF PERIOD | CHARGED TO COSTS AND EXPENSES | DEDUCTIO (a) |
|----------------|-----------------------------------|----------------------------------|-----------------|
|----------------|-----------------------------------|----------------------------------|-----------------|

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| 2001 | | | |
|---------------------------------|-------------|-------------|---------------|
| Allowance for doubtful accounts | \$2,291,000 | \$3,425,000 | \$(4,063,000) |
| | ===== | ===== | ===== |
| 2000 | | | |
| Allowance for doubtful accounts | \$1,665,000 | \$5,408,000 | \$(4,782,000) |
| | ===== | ===== | ===== |
| 1999 | | | |
| Allowance for doubtful accounts | \$1,398,000 | \$1,721,000 | \$(1,454,000) |
| | ===== | ===== | ===== |

(a) Accounts receivable write-off