

MERCURY AIR GROUP INC

Form 10-Q

February 17, 2004

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**UNITED STATES OF AMERICA  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

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**Form 10-Q**

(Mark One)

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

**For the quarterly period ended December 31, 2003**

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

**For the transition period from            to**

**Commission File No. 1-7134**

**Mercury Air Group, Inc.**

*(Exact name of registrant as specified in its charter)*

**Delaware**  
*(State or other jurisdiction of  
incorporation or organization)*

**11-1800515**  
*(I.R.S. Employer  
Identification Number)*

**5456 McConnell Avenue**  
**Los Angeles, CA**  
*(Address of principal executive offices)*

**90066**  
*(Zip Code)*

**Registrant's telephone number, including area code:**  
**(310) 827-2737**

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 whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes  No

Indicate the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date.

| Title                          | Number of Shares Outstanding<br>as of January 7, 2004 |
|--------------------------------|---|
| Common Stock, \$0.01 Par Value | 2,954,818   |



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CONSOLIDATED BALANCE SHEETS**

|  | <b>December 31,<br/>2003</b> | <b>June 30,<br/>2003</b> |
|--|------------------------------|--------------------------|
|  | <b>(Unaudited)</b>           |                          |
| <b>ASSETS</b>  |                              |                          |
| <b>CURRENT ASSETS:</b>   |                              |                          |
| Cash and cash equivalents  | \$ 3,387,000                 | \$ 2,802,000             |
| Trade accounts receivable, net of allowance for doubtful accounts of \$2,054,000 and \$2,006,000 at December 31 and June 30, 2003, respectively                      | 52,036,000                   | 46,753,000               |
| Inventories, principally aviation fuel   | 4,034,000                    | 4,422,000                |
| Prepaid expenses and other current assets  | 5,276,000                    | 5,241,000                |
| Deferred income taxes  | 1,339,000                    | 901,000                  |
|  | <hr/>                        | <hr/>                    |
| Total current assets   | 66,072,000                   | 60,119,000               |
| PROPERTY, EQUIPMENT AND LEASEHOLDS, net of accumulated depreciation and amortization of \$64,829,000 and \$61,061,000 at December 31 and June 30, 2003, respectively | 57,649,000                   | 58,844,000               |
| NOTES RECEIVABLE, net of allowance for doubtful accounts of \$457,000 and \$509,000 at December 31 and June 30, 2003, respectively                                   | 1,239,000                    | 1,815,000                |
| DEFERRED INCOME TAXES  | 2,847,000                    | 2,284,000                |
| GOODWILL   | 4,389,000                    | 4,389,000                |
| OTHER INTANGIBLE ASSETS, NET   | 883,000                      | 1,033,000                |
| OTHER ASSETS, NET  | 3,937,000                    | 4,471,000                |
|  | <hr/>                        | <hr/>                    |
| <b>TOTAL ASSETS</b>  | <b>\$137,016,000</b>         | <b>\$132,955,000</b>     |
|  | <hr/>                        | <hr/>                    |
| <b>LIABILITIES, MANDATORILY REDEEMABLE PREFERRED STOCK<br/>AND STOCKHOLDERS EQUITY</b>   |                              |                          |
| <b>CURRENT LIABILITIES:</b>  |                              |                          |
| Accounts payable   | \$ 37,349,000                | \$ 34,677,000            |
| Accrued expenses and other current liabilities   | 12,334,000                   | 9,554,000                |
| Current portion of long-term debt  | 4,143,000                    | 4,194,000                |
|  | <hr/>                        | <hr/>                    |
| Total current liabilities  | 53,826,000                   | 48,425,000               |
| LONG-TERM DEBT   | 23,273,000                   | 25,501,000               |
| SENIOR SUBORDINATED NOTE   | 23,533,000                   | 23,445,000               |
| SUBORDINATED NOTE  | 3,586,000                    |                          |
| OTHER LONG TERM LIABILITIES  | 1,265,000                    | 608,000                  |
| DEFERRED RENT  | 1,571,000                    | 1,885,000                |
| MINORITY INTEREST  | 195,000                      | 180,000                  |
|  | <hr/>                        | <hr/>                    |
| Total liabilities  | 107,249,000                  | 100,044,000              |
| <b>COMMITMENTS AND CONTINGENCIES (Note 5)</b>  |                              |                          |
| MANDATORILY REDEEMABLE PREFERRED STOCK, Series A \$0.01 par value; 1,000,000 shares authorized; 462,627 shares outstanding at December 31 and June 30, 2003          | 500,000                      | 481,000                  |

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| STOCKHOLDERS EQUITY:  |   |                       |                       |
|---|---|-----------------------|-----------------------|
| Preferred Stock   | \$0.01 par value; authorized 2,000,000 shares; no shares outstanding  |                       |                       |
| Common Stock  | \$0.01 par value; authorized 18,000,000 shares; 2,954,818 and 3,293,568 shares outstanding at December 31 and June 30, 2003, respectively | 30,000                | 33,000                |
| Additional paid-in capital  |   | 20,726,000            | 22,496,000            |
| Retained earnings   |   | 12,181,000            | 14,018,000            |
| Accumulated other comprehensive income (loss)                                     |   | 62,000                | (86,000)              |
| Notes receivable from officers  |   | (3,732,000)           | (4,031,000)           |
|   |   | <u>29,267,000</u>     | <u>32,430,000</u>     |
|   |   |                       |                       |
| Total liabilities, mandatorily redeemable preferred stock and stockholders equity |   | <u>\$ 137,016,000</u> | <u>\$ 132,955,000</u> |

See accompanying notes to consolidated financial statements.

**Table of Contents****MERCURY AIR GROUP, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF OPERATIONS**

|  | Six Months Ended<br>December 31, |                       | Three Months Ended<br>December 31, |                     |
|--|----------------------------------|-----------------------|------------------------------------|---------------------|
|  | 2003                             | 2002                  | 2003                               | 2002                |
|  | (Unaudited)                      |                       | (Unaudited)                        |                     |
| <b>Sales and revenues:</b>                             |                                  |                       |                                    |                     |
| Sales  | \$ 167,865,000                   | \$ 175,336,000        | \$ 89,289,000                      | \$ 89,886,000       |
| Service revenues                                       | 47,035,000                       | 46,521,000            | 24,598,000                         | 24,076,000          |
| Total sales and revenues                               | <u>214,900,000</u>               | <u>221,857,000</u>    | <u>113,887,000</u>                 | <u>113,962,000</u>  |
| <b>Costs and expenses:</b>                             |                                  |                       |                                    |                     |
| Cost of sales  | 147,585,000                      | 156,247,000           | 78,599,000                         | 80,213,000          |
| Operating expenses                                     | 53,688,000                       | 52,772,000            | 28,376,000                         | 26,861,000          |
| Total costs and expenses                               | <u>201,273,000</u>               | <u>209,019,000</u>    | <u>106,975,000</u>                 | <u>107,074,000</u>  |
| Gross margin (excluding depreciation and amortization) | <u>13,627,000</u>                | <u>12,838,000</u>     | <u>6,912,000</u>                   | <u>6,888,000</u>    |
| <b>Expenses (income):</b>                              |                                  |                       |                                    |                     |
| Selling, general and administrative                    | 5,040,000                        | 5,241,000             | 2,765,000                          | 2,651,000           |
| Provision for bad debts                                | 60,000                           | 759,000               | (323,000)                          | 407,000             |
| Depreciation and amortization                          | 4,279,000                        | 4,049,000             | 2,108,000                          | 1,998,000           |
| Interest expense                                       | 4,525,000                        | 2,915,000             | 1,931,000                          | 1,533,000           |
| Hambro settlement costs                                | 1,799,000                        |                       | 1,799,000                          |                     |
| Debt extinguishment costs                              |                                  | 1,733,000             |                                    | 1,208,000           |
| Interest income  | (245,000)                        | (50,000)              | (32,000)                           |                     |
| Total expenses (income)                                | <u>15,458,000</u>                | <u>14,647,000</u>     | <u>8,248,000</u>                   | <u>7,797,000</u>    |
| Loss before income tax provision (benefit)             | (1,831,000)                      | (1,809,000)           | (1,336,000)                        | (909,000)           |
| Income tax provision (benefit)                         | (12,000)                         | (624,000)             | 181,000                            | (313,000)           |
| Net loss   | <u>\$ (1,819,000)</u>            | <u>\$ (1,185,000)</u> | <u>\$ (1,517,000)</u>              | <u>\$ (596,000)</u> |
| Accrued preferred stock dividends                      | (19,000)                         |                       | (9,000)                            |                     |
| Net loss applicable to common stockholders             | <u>\$ (1,838,000)</u>            | <u>\$ (1,185,000)</u> | <u>\$ (1,526,000)</u>              | <u>\$ (596,000)</u> |
| <b>Net loss per common share:</b>                      |                                  |                       |                                    |                     |
| Basic:   | <u>\$ (0.56)</u>                 | <u>\$ (0.37)</u>      | <u>\$ (0.47)</u>                   | <u>\$ (0.18)</u>    |
| Diluted:   | <u>\$ (0.56)</u>                 | <u>\$ (0.37)</u>      | <u>\$ (0.47)</u>                   | <u>\$ (0.18)</u>    |

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See accompanying notes to consolidated financial statements.



**Table of Contents****MERCURY AIR GROUP, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS**

|  | Six Months Ended<br>December 31, |                    |
|--|----------------------------------|--------------------|
|  | 2003                             | 2002               |
|  | (Unaudited)                      |                    |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                   |                                  |                    |
| Net loss   | \$(1,819,000)                    | \$ (1,185,000)     |
| Adjustments to derive cash flow from operating activities:     |                                  |                    |
| Bad debt expense   | 60,000                           | 759,000            |
| Depreciation and amortization                                  | 4,279,000                        | 4,049,000          |
| Deferred income taxes  | (1,001,000)                      | 3,000              |
| Deferred rent  | (314,000)                        | 257,000            |
| Compensation expense related to rereasurement of stock options |                                  | 318,000            |
| Executive loan amortization                                    | 194,000                          | 202,000            |
| Write-down of note receivable from officer                     | 105,000                          |                    |
| Hambro settlement costs  | 1,799,000                        |                    |
| Amortization of senior subordinated note discount              | 88,000                           | 176,000            |
| Loss (gain) on retirement of assets                            | (1,000)                          | 27,000             |
| Write-off of deferred financing costs                          |                                  | 1,733,000          |
| Minority interest  | 15,000                           |                    |
| Changes in operating assets and liabilities:                   |                                  |                    |
| Trade and other accounts receivable                            | (5,343,000)                      | (5,151,000)        |
| Inventories  | 388,000                          | (998,000)          |
| Prepaid expenses and other current assets                      | (35,000)                         | (123,000)          |
| Accounts payable   | 2,672,000                        | 76,000             |
| Accrued expenses and other current liabilities                 | 3,437,000                        | (1,866,000)        |
|  | <u>4,524,000</u>                 | <u>(1,345,000)</u> |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                   |                                  |                    |
| Decrease in restricted cash                                    |                                  | 3,780,000          |
| Decrease (increase) in other assets                            | 252,000                          | (1,164,000)        |
| Decrease in notes receivable                                   | 576,000                          | 86,000             |
| Proceeds from sale of property                                 | 9,000                            | 35,000             |
| Additions to property, equipment and leaseholds                | (2,638,000)                      | (3,551,000)        |
|  | <u>(1,801,000)</u>               | <u>(814,000)</u>   |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                   |                                  |                    |
| Net increase (decrease) in debt instruments                    | (2,278,000)                      | 800,000            |
| Early retirement of debt                                       |                                  | (13,285,000)       |
| Proceeds from refinancing                                      |                                  | 16,923,000         |
| Capitalization of deferred financing costs                     |                                  | (3,351,000)        |
| Repurchase of common stock                                     |                                  | (370,000)          |
| Proceeds from issuance of preferred stock                      |                                  | 259,000            |
| Proceeds from exercise of stock options                        | 14,000                           | 58,000             |
|  | <u>(2,264,000)</u>               | <u>1,034,000</u>   |
| Effect of exchange rate changes on cash                        | 126,000                          | (45,000)           |

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|   |                   |                   |
|---|-------------------|-------------------|
| <b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b> | 585,000           | (1,170,000)       |
| <b>CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD</b>       | 2,802,000         | 5,565,000         |
|   | <u>          </u> | <u>          </u> |
| <b>CASH AND CASH EQUIVALENTS, END OF PERIOD</b>             | \$ 3,387,000      | \$ 4,395,000      |
|   | <u>          </u> | <u>          </u> |
| <b>CASH PAID DURING THE PERIOD FOR:</b>                     |                   |                   |
| Interest  | \$ 2,952,000      | \$ 2,630,000      |
| Income taxes  | \$ 726,000        | \$ 4,670,000      |

See accompanying notes to consolidated financial statements.

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**MERCURY AIR GROUP, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**December 31, 2003**

**(Unaudited)**

**Note 1 General**

***Business***

Mercury Air Group, Inc. (the Company), a Delaware Corporation, was organized in 1956 and provides a broad range of services to the aviation industry through four principal operating units: Mercury Air Centers, Inc. (Air Centers), Mercury Air Cargo, Inc. (Air Cargo), MercFuel, Inc. (MercFuel) and Maytag Aircraft Corporation (Maytag), a provider of government contract services. The Air Centers operations consist of aviation fuel sales, commercial aircraft refueling operations (into-plane), aircraft ground support services, aircraft hangar services, secured aircraft parking (aircraft tie-down services) and aircraft maintenance at certain Air Center locations, known as Fixed Based Operations (FBOs), for commercial, private, general aviation and United States Government aircraft (collectively FBO services). Air Cargo operations consist of cargo handling, the sale of cargo capacity on other airlines (Cargo Space Logistics), and general cargo sales agent services. MercFuel operations consist of the sale and delivery of fuel, primarily aviation fuel, to domestic and international commercial airlines, corporate aviation and air freight airlines. Maytag's government contract services consist of the following services primarily for agencies of the United States Government: aircraft refueling and fuel storage operations, base operations support (BOS) services, air terminal and ground handling services and weather observation and forecasting services.

On October 28, 2003, the Company announced that it had entered into a definitive agreement, subject to the Company's stockholders approval, completion of due diligence, and regulatory agencies' approvals and consents, to sell 100% of the outstanding common stock of Air Centers to Allied Capital Corporation (Allied) for \$70 million, subject to adjustments (the FBO Sale). In accordance with the terms of the definitive agreement, as amended, closing of this transaction is to occur on or before May 14, 2004. The Company currently expects to close the FBO Sale either late in the Company's third quarter or early in the Company's fourth quarter of fiscal 2004.

***Risks and Uncertainties***

On October 28, 2003 the Company announced that it had entered into a definitive agreement for Allied to purchase 100% of the outstanding common stock of Air Centers from the Company, subject to, among other things, the Company's stockholders' approval, completion of due diligence and regulatory agency approvals (the Definitive Agreement). The purchase price for the Air Centers is \$70 million, subject to adjustment for, among other things, working capital and for certain FBO capital expenditures made by the Company. At the close of the FBO Sale, \$8.3 million from the sale proceeds will be deposited into an escrow account pending the award of a new lease for the FBO located at Atlanta's Hartsfield International Airport. In accordance with the terms of the Definitive Agreement the closing date for the FBO Sale was to be December 31, 2003 with Allied having the right to extend the closing date through March 31, 2004. On December 5, 2003, the Company and its lenders under the Senior Secured Credit Facility (the Lenders) executed the Fifth Amendment to the Loan and Security Agreement and Forebearance Agreement (the Forebearance Agreement), which was amended on February 16, 2004. Among other things, the Company requested the Lenders and the Lenders agreed to forebear from exercising their rights and remedies under the Senior Secured Credit Facility for the following events of default, as defined in the Loan and Security Agreement: (1) the Company's failure to deliver its annual audited financial statements for fiscal year 2003 within the prescribed time-frame allowed; (2) the formation of a subsidiary, Mercury Air Center - Long Beach, without the prior consent of the lenders; (3) the Company's failure to deliver supplemental schedules to J. H. Whitney as required under the terms of the \$24 million Senior Secured 12% Note; and (4) the Company's failure to achieve the EBITDA financial covenant for the twelve month period ended December 31, 2003. The Forebearance Agreement, as amended, states that the Lenders agree, for a limited time but no later than April 14, 2004, to forebear from exercising their rights and remedies under the Senior Secured Credit Facility with respect to the events of default noted above. The Company and Allied have amended the Definitive Agreement whereby the closing date of the FBO Sale is to occur on or before May 14, 2004. If the FBO Sale does not close by April 14, 2004, the Company and the Lenders will need to amend the FBO Sale closing date in the Forebearance Agreement or the Lenders would have the right to exercise their rights and remedies under the Senior Secured Credit Facility with respect to the events of default noted above.

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On January 20, 2004, the Los Angeles World Airports (LAWA) Board of Commissioners approved a rental increase for one of Air Cargo's warehouse facilities located at Los Angeles International Airport (the Avion Warehouse) that is effective retroactive to June 18, 2001. The monthly rent will increase to \$251,000, an increase of \$64,000, or 25.4%, from the previous monthly rent of \$187,000. The total amount of the retroactive portion of the rental increase from June 18, 2001 to January 31, 2004 is \$2,002,000 (the Retroactive Increase), which will be partially offset by recoverable retroactive sublease rental income of \$850,000. The provisions of the rental increase allow for the Retroactive Increase to be paid by the Company in monthly installments of \$75,000, including interest, over the remaining term of the lease, which is due to expire on June 17, 2006. As of December 31, 2003, the Company has accrued \$1,143,000 for the Retroactive Increase. Of this amount, \$113,000 was recorded in each of the Company's first two quarters of fiscal 2004.

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 the aviation industry, 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 may 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. 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.

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.

### ***Basis of Presentation***

The accompanying unaudited financial statements of Mercury Air Group, Inc. and subsidiaries (the Company) have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission for interim financial information. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments consisting of normal recurring adjustments and accruals necessary for a fair presentation have been reflected in these financial statements. Operating results for the quarter are not necessarily indicative of the results that may be expected for the fiscal year ending June 30, 2004 due to seasonal and other factors. In order to maintain consistency and comparability between periods presented, certain prior period amounts have been reclassified to conform to the current period presentation. The accompanying financial statements should be read in conjunction with the audited consolidated financial statements and footnotes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended June 30, 2003.

### ***New Accounting Pronouncements***

On April 30, 2003, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities. This standard amends and clarifies the accounting for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities under SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities. The provisions of this statement are generally effective for contracts entered into or modified after June 30, 2003. The Company adopted SFAS No.149 on July 1, 2003 with no material impact on the Company's consolidated financial statements.

In January 2003, the FASB issued Interpretation No. 46, Consolidation of Variable Interest Entities (FIN 46). This interpretation of Accounting Research Bulletin No. 51, Consolidated Financial Statements, addresses consolidation by business enterprises of variable interest entities. Under current practice, two enterprises generally have been included in consolidated financial statements because one enterprise controls the other through voting interests. FIN 46 defines the concept of variable interests and requires existing unconsolidated variable interest entities to be consolidated by their primary beneficiaries if the entities do not effectively disperse risks among the parties involved. This interpretation applies immediately to variable interest entities created after January 31, 2003. It applies in the first fiscal year or interim period beginning after December 15, 2003, to variable interest entities considered to be a special purpose entity (SPE) in which an enterprise holds a variable interest that it acquired before February 1, 2003. For non-SPE variable interest entities acquired before February 1, 2003, the interpretation must be adopted no later than the first interim or annual period ending after March 15, 2004. The interpretation may be applied prospectively with a cumulative-effect

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adjustment as of the date on which it is first applied or by restating previously issued financial statements for one or more years with a cumulative-effect adjustment as of the beginning of the first year restated. The Company is currently evaluating the potential impact of the adoption of FIN 46.

In May 2003, the FASB issued SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity, which establishes standards for the classification and measurement of certain financial instruments with characteristics of both liabilities and equity. SFAS No. 150 requires classification of financial instruments within its scope as a liability, including financial instruments issued in the form of shares that are mandatorily redeemable, because those financial instruments are deemed to be, in essence, obligations of the issuer. SFAS No. 150 is effective for the Company for the interim period ending March 31, 2004. The Company does not expect that the adoption of this standard will have a material impact on its consolidated financial statements.

**Note 2 Stock-Based Employee Compensation**

In December 2002, the FASB issued SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure. SFAS No. 148 provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. The Company has elected to continue utilizing the intrinsic value method to account for stock-based compensation as allowed by SFAS No. 123, Accounting for Stock-Based Compensation.

SFAS No. 148 also amends the disclosure requirements of SFAS No. 123, to require disclosure in both interim and annual financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. SFAS No. 148 is effective for the Company's fiscal year ended June 30, 2003 and for interim financial statements beginning January 1, 2003.

The Company has five stock option plans. As permitted under SFAS No. 123, the Company measures compensation expense related to employee stock options granted utilizing the intrinsic value method as prescribed by Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations under the intrinsic value method. The following table illustrates the pro forma effect on the net loss if the Company had applied the fair value recognition provisions of SFAS No. 123 to stock-based employee compensation.

|  | Six Months Ended<br>December 31, |                      | Three Months Ended<br>December 31, |                    |
|--|----------------------------------|----------------------|------------------------------------|--------------------|
|  | 2003                             | 2002                 | 2003                               | 2002               |
| Net loss, as reported  | \$(1,819,000)                    | \$(1,185,000)        | \$(1,517,000)                      | \$(596,000)        |
| Add stock-based employee compensation expense included in net loss, net of tax                                       | 123,000                          | 340,000              | 61,000                             | 66,000             |
| Less total stock based employee compensation determined under the fair value based method for all awards, net of tax | (59,000)                         | (285,000)            | (27,000)                           | (87,000)           |
| Pro forma net loss   | <u>\$(1,755,000)</u>             | <u>\$(1,130,000)</u> | <u>\$(1,483,000)</u>               | <u>\$(617,000)</u> |

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|  |           |           |           |           |
|--|-----------|-----------|-----------|-----------|
| Basic net loss<br>per share as<br>reported   | \$ (0.56) | \$ (0.37) | \$ (0.47) | \$ (0.18) |
| Basic net loss<br>per share pro<br>forma     | \$ (0.54) | \$ (0.35) | \$ (0.46) | \$ (0.19) |
| Diluted net<br>loss per share<br>as reported | \$ (0.56) | \$ (0.37) | \$ (0.47) | \$ (0.18) |
| Diluted net<br>loss per share<br>pro forma   | \$ (0.54) | \$ (0.35) | \$ (0.46) | \$ (0.19) |

**Note 3 Bad Debt Expense**

During the second quarter of fiscal 2004, the Company reversed previously established bad debt reserves as a result of better than expected customers collections experience over the past three quarters. This reversal resulted in a reduction of bad debt expense of \$323,000 for the second quarter of fiscal 2004 and a provision for bad debt expense of \$60,000 for the first six months of fiscal 2004.

**Note 4 Income Taxes**

Income taxes have been computed based on the estimated annual effective income tax rates for the respective periods. The following is a reconciliation of the federal statutory rate to the Company's effective tax rate on pretax loss:

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|   | Six Months Ended |         | Three Months Ended |         |
|---|------------------|---------|--------------------|---------|
|   | December 31,     |         | December 31,       |         |
|   | 2003             | 2002    | 2003               | 2002    |
| Federal tax (benefit) at statutory rate             | (34.0%)          | (34.0%) | (34.0%)            | (34.0%) |
| State income tax benefit, net of federal income tax | (5.0)            | (2.7)   | (5.0)              | (2.7)   |
| Non-deductible Hambro settlement costs              | 38.3             |         | 52.5               |         |
| Non-deductible expenses, other                      |                  | 1.9     |                    | 1.9     |
| Other, net  |                  | 0.3     |                    | 0.3     |
| Effective income tax rate                           | (0.7%)           | (34.5%) | 13.5%              | (34.5%) |

The Hambro settlement costs of \$1,799,000 recognized by the Company in the second quarter of fiscal 2004 is not deductible in the determination of taxable income resulting in a permanent book to tax difference. The difference results in an increase in the income tax provision of \$702,000 for the three and six month periods ended December 31, 2003.

**Note 5 Litigation**

The Company is 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 material effect on its consolidated financial statements. Reference is made to the Company's Quarterly Report on Form 10-Q for the period ended September 30, 2003 for additional legal matters with respect to which no material developments have occurred in the current quarter.

**Note 6 Debt**

On December 30, 2002, the Company entered into a loan and security agreement (the Facility), refinancing its senior secured credit facilities with Foothill Capital Corporation (Foothill), a division of Wells Fargo Bank, for a five-year term.

The Facility provides a total of up to \$42.5 million in revolving and term loans. The term loan is for an amount equal to \$12.5 million, while the revolving loan is for an amount not to exceed 85% of Eligible Accounts Receivable (as defined in the loan agreement), subject to certain limitations. The term loan is payable in \$1.0 million installments each April 1 and October 1 and in \$0.5 million installments each July 1 and December 31, until paid in full. Amounts repaid under the term loan increase the maximum availability under the revolving loan. The Facility also provides for the issuance of certain letters of credit. The terms of the Facility requires that the Company maintain a minimum availability on the revolving line of credit of \$2.5 million. As of December 31, 2003, the Company had \$7.1 million of availability on the revolving line of credit. The amount of the available revolving credit line fluctuates on a daily basis dependent upon the amount of Eligible Receivables and the amount of letters of credit outstanding and the amount of outstanding cash borrowings against the revolving credit facility.

The Facility may be terminated on December 23, 2005, if the Note is not paid in full or refinanced, on terms acceptable to Foothill, prior to October 31, 2005. The Facility is collateralized by substantially all of the assets of the Company and its subsidiaries. The Facility contains provisions that require the maintenance of certain financial ratios including minimum EBITDA levels, minimum fixed charge coverage ratios, and maximum annual capital expenditure levels. In addition, under the Facility, the Company is prohibited from paying non-intercompany cash dividends.

On December 5, 2003, as amended on February 16, 2004, the Company and its lenders under the Senior Secured Credit Facility executed the Fifth Amendment to the Loan and Security Agreement and Forebearance Agreement (the Forebearance Agreement). Among other things, the Company requested the lenders and the lenders agreed to forebear from exercising their rights and remedies under the Senior Secured Credit Facility for the following events of default, as defined in the Loan and Security Agreement: (1) the Company's failure to deliver its annual audited financial statements for fiscal 2003 within the prescribed time-frame allowed; (2) the formation of a subsidiary, Mercury Air Center Long Beach, without the prior consent of the lenders; (3) the Company's failure to deliver supplemental schedules to J. H. Whitney as required under the terms of the \$24 million Senior Secured 12% Note; and (4) the Company's failure to achieve the EBITDA financial covenant

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for the twelve month period ended December 31, 2003. The Forebearance Agreement, as amended, states that the lenders agree, for a limited time but no later than April 14, 2004, to forebear from exercising their rights and remedies under the Senior Secured Credit Facility with respect to the events of default noted above. The Company and Allied have amended the Definitive Agreement whereby the closing date of the FBO Sale is now on a date on or prior to May 14, 2004. If the FBO Sale does not close by April 14, 2004, the Company and the Lenders will need to amend the FBO Sale closing date in the Forebearance Agreement or the Lenders would have the right to exercise their rights and remedies under the Senior Credit Facility with respect to the events of default noted above.

On October 28, 2003, Allied acquired the \$24 million Senior Subordinated 12% Note (the Note), as amended on December 30, 2002 from J. H. Whitney Co. Mezzanine Fund and waived certain provisions of the Note, which would have required the Company to provide the Noteholder with the following: 1) if the principal amount outstanding on the Note was not prepaid in full by December 31, 2003, the Noteholder would have been entitled to warrants to acquire from the Company, for a nominal amount, 5% of the then outstanding shares of the Company's common stock and 2) if the principal amount outstanding on the Note exceeded \$12 million on December 31, 2003 the Noteholder would have been entitled to: a) a second set of warrants to acquire from the Company, for a nominal amount, 5% of the then outstanding shares of the Company's common stock and b) an additional Note in the original principal amount of \$5 million. The Note, subordinated to the Facility, is collateralized by the Company's assets. Interest on the Note is due and payable at the end of each calendar quarter and, effective January 2004 and continuing through June 2004, the interest rate will increase by 1% per month up to a maximum total interest rate of 18% with the amount of interest in excess of 12% being added to the principal of the Note at the end of each calendar month. The Note matures on December 31, 2005.



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The Note contains covenants that, among other matters, limit senior indebtedness, the payment of dividends, and limits the disposition of assets and the maintenance of certain financial measurements including EBITDA requirements and limits on capital expenditures.

On December 12, 2003, the Company issued three promissory notes for an aggregate principal amount of \$3,586,000 (the Hambro Notes). The Hambro Notes, subordinated to the Facility and the Note, accrue interest at the rate of 12% per annum increasing to 16% per annum for any amount of unpaid principal after June 30, 2004. The Hambro Notes mature at the earlier of (1) the ninetieth day following payment in full of the Facility and the termination of commitments for the Lenders to provide financing under the Facility or (2) March 31, 2006, provided that if the Facility matures on December 31, 2007 then such date shall be March 31, 2008.

**Note 7 Hambro Settlement Costs**

On December 12, 2003, the Company entered into a settlement agreement (the Hambro Settlement) relating to litigation with J O Hambro Capital Management and certain of its affiliates and private clients (collectively J O Hambro) whereby the Company issued three promissory notes for an aggregate principle amount of \$3,586,000 (the Hambro Notes) in exchange for the following, among other things: (1) the release of certain claims by J O Hambro; (2) the Company's agreement to dismiss litigation against J O Hambro; (3) the Company's agreement not to institute certain litigation against J O Hambro and certain other parties; (4) reimbursement of certain costs associated with the pending litigation and the defense preparation for anticipated litigation between the parties; and (5) the purchase of 343,600 shares of the Company's common stock in exchange for the Hambro Notes. The settlement cost of \$1,799,000 recognized in the second quarter of fiscal 2004 represents the difference between the face value of the Hambro Notes and the trading value of the shares of common stock acquired by the Company on the day of the Hambro Settlement.

**Note 8 Net Income (Loss) Per Share**

Basic net income (loss) per share is computed by dividing net income (loss) by the weighted average number of common shares outstanding during the period. Diluted net income (loss) per share is computed by dividing net income (loss) by the weighted average number of common shares and potential common shares except for amounts that are antidilutive. Potential common shares include stock options and shares resulting from the assumed conversion of subordinated debentures, when dilutive.

|  | Six Months Ended  |           |                   |           | Three Months Ended |           |                   |           |
|--|-------------------|-----------|-------------------|-----------|--------------------|-----------|-------------------|-----------|
|  | December 31, 2003 |           | December 31, 2002 |           | December 31, 2003  |           | December 31, 2002 |           |
|  | Diluted           | Basic     | Diluted           | Basic     | Diluted            | Basic     | Diluted           | Basic     |
| Weighted average number of common shares outstanding during the period                       | 3,283,385         | 3,283,385 | 3,237,500         | 3,237,500 | 3,268,211          | 3,268,211 | 3,243,000         | 3,243,000 |
| Common share equivalents resulting from the assumed exercise of stock options                |                   |           |                   |           |                    |           |                   |           |
| Weighted average number of common and common equivalent shares outstanding during the period | 3,283,385         | 3,283,385 | 3,237,500         | 3,237,500 | 3,268,211          | 3,268,211 | 3,243,000         | 3,243,000 |

**Note 9 Segment Reporting**

The Company discloses segment information in accordance with SFAS No. 131, Disclosure About Segments of an Enterprise and Related Information, which requires companies to report selected segment information on a quarterly basis and to report certain entity-wide disclosures about products and services, major customers and material countries in which the entity holds assets and reports revenues. The operating segments reported below are the segments of the Company for which operating results are evaluated regularly by management in deciding how

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to allocate resources and in assessing performance. Intersegment sales are not significant.

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.

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|   | Fuel Sales | Fixed Base<br>Operations | Cargo<br>Operations | Government<br>Contract<br>Services | Corporate<br>or<br>Unallocated | Total     |
|---|------------|--------------------------|---------------------|------------------------------------|--------------------------------|-----------|
| (Dollars in Thousands)                    |            |                          |                     |                                    |                                |           |
| <b>Quarter Ended December 31, 2003</b>    |            |                          |                     |                                    |                                |           |
| Sales and revenues                        | \$ 74,901  | \$23,450                 | \$10,683            | \$ 5,915                           | \$ (1,062)                     | \$113,887 |
| Gross margin                              | 1,874      | 3,084                    | 523                 | 1,431                              |                                | 6,912     |
| Depreciation and amortization             | 119        | 1,319                    | 459                 | 79                                 | 132                            | 2,108     |
| Capital expenditures                      | 2          | 1,349                    | 26                  | 89                                 | 12                             | 1,478     |
| Segment assets                            | 29,788     | 59,864                   | 18,979              | 10,489                             | 17,896                         | 137,016   |
| <b>Quarter Ended December 31, 2002</b>    |            |                          |                     |                                    |                                |           |
| Sales and revenues                        | \$ 75,041  | \$23,882                 | \$ 9,154            | \$ 6,314                           | \$ (429)                       | \$113,962 |
| Gross margin                              | 1,451      | 2,941                    | 1,300               | 1,196                              |                                | 6,888     |
| Depreciation and amortization             | 54         | 1,328                    | 546                 | 90                                 | (20)                           | 1,998     |
| Capital expenditures                      | 6          | 2,652                    |                     |                                    | 283                            | 2,941     |
| Segment assets                            | 34,346     | 60,244                   | 16,241              | 11,564                             | 16,515                         | 138,910   |
| <b>Six Months Ended December 31, 2003</b> |            |                          |                     |                                    |                                |           |
| Sales and revenues                        | \$139,890  | \$45,983                 | \$19,577            | \$11,742                           | \$ (2,292)                     | \$214,900 |
| Gross margin                              | 3,300      | 6,288                    | 1,296               | 2,743                              |                                | 13,627    |
| Depreciation and amortization             | 234        | 2,699                    | 917                 | 160                                | 269                            | 4,279     |
| Capital expenditures                      | 639        | 1,834                    | 38                  | 106                                | 21                             | 2,638     |
| Segment assets                            | 29,788     | 59,864                   | 18,979              | 10,489                             | 17,896                         | 137,016   |
| <b>Six Months Ended December 31, 2002</b> |            |                          |                     |                                    |                                |           |
| Sales and revenues                        | \$145,614  | \$47,708                 | \$16,444            | \$12,520                           | \$ (429)                       | \$221,857 |
| Gross margin                              | 3,071      | 5,914                    | 1,704               | 2,149                              |                                | 12,838    |
| Depreciation and amortization             | 108        | 2,581                    | 1,092               | 181                                | 87                             | 4,049     |
| Capital expenditures                      | 6          | 3,176                    | 65                  |                                    | 304                            | 3,551     |
| Segment assets                            | 34,346     | 60,244                   | 16,241              | 11,564                             | 16,515                         | 138,910   |

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Gross margin is used as the measure of profit and loss for segment reporting purposes as it is 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 (benefit) for Fuel Sales was approximately \$(519,000) and \$339,000 for the quarters ended December 31, 2003 and 2002, respectively; total bad debt expense (benefit) was \$(323,000) and \$407,000 in the quarters ended December 31, 2003 and 2002, respectively. Bad debt (benefit) expense for Fuel Sales was approximately \$(180,000) and \$632,000 for the six month periods ended December 31, 2003 and 2002, respectively; total bad debt expense was \$60,000 and \$759,000 for the six month periods ended December 31, 2003 and 2002, respectively.

### Note 10 Comprehensive Loss

Comprehensive loss is summarized as follows:

|   | Six Months Ended<br>December 31, |               | Three Months Ended<br>December 31, |             |
|---|----------------------------------|---------------|------------------------------------|-------------|
|   | 2003                             | 2002          | 2003                               | 2002        |
| Net loss                                | \$(1,819,000)                    | \$(1,185,000) | \$(1,517,000)                      | \$(596,000) |
| Foreign currency translation adjustment | 148,000                          | (45,000)      | 140,000                            | (6,000)     |
| Comprehensive loss                      | \$(1,671,000)                    | \$(1,230,000) | \$(1,377,000)                      | \$(602,000) |

### Note 11 Related Party Transactions

CFK Partners and CFK Realty Partners, LLC are entities consisting of three of the Company's directors, one of whom also serves as the Company's Chief Executive Officer and another who serves as Chairman of the Board and another who serves as outside counsel on various general corporate legal matters. In addition, CFK Partners also owns approximately 24.5% of the Company's issued and outstanding common and preferred stock.

In January 2002, the Company sold the land and the office building which houses its corporate headquarters to CFK Realty Partners, LLC (CFK Realty) for \$4,200,000, consisting of \$2,800,000 in cash and a note receivable of \$1,400,000. The note accrues interest at 5% and contains provisions whereby CFK Realty can elect to extend the maturity date in one year increments through December 31, 2004. The note had an original maturity date of December 31, 2002. In early December 2003, the Company received notification from CFK Realty that it was exercising its right to extend the maturity date of the note for an additional one year period.

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Concurrently with the sale, the Company also entered into a ten-year lease of the property for a monthly rental amount of approximately \$37,000. CFK Realty financed the purchase of the building through a \$3.2 million loan. CFK Realty is included in the Company's consolidated financial statements included herein.

The Company and its Chairman (collectively, the Members) each own an equity interest in MercMed LLC (MercMed) of 64.94% and 35.06%, respectively. Accordingly, MercMed has been included in the Company's consolidated financial statements and the liability to the minority interest has also been reflected in the consolidated balance sheets. Minority interest on the Company's consolidated balance sheet represents the minority member's equity in MercMed. MercMed was formed for the purpose of owning and operating an aircraft for the Members. On March 27, 2003, MercMed obtained new financing for the aircraft which is a 15-year loan with the interest rate being fixed for the initial 36-month period. At the end of the initial 36-month period, the interest rate will be reviewed and fixed at the then Federal Home Loan Bank's regular three-year interest rate plus 275 basis points. Each of the Members are guarantors of this note. The outstanding principal amount of the loan as of December 31, 2003 was \$683,000.

The Company uses the services of the legal firm McBreen and Kopko (the Firm) for various general corporate legal matters. Mr. Frederick H. Kopko, Jr., a partner of the Firm, is a member of the Company's Board of Directors and is a partner with CFK Partners. For the six month periods ended December 31, 2003 and 2002, the Company paid the Firm \$481,000 and \$215,000, respectively, for legal services rendered. For the three month periods ended December 31, 2003 and 2002, the Company paid the Firm \$339,000 and \$81,000, respectively.

**Table of Contents****Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

*Results of Operations* Comparison of the three months ended December 31, 2003 and December 31, 2002 and comparison of the six months ended December 31, 2003 and December 31, 2002.

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

|                               | Six Months Ended December 31, |                            |                   |                            | Three Months Ended December 31, |                            |                 |                            |
|-------------------------------|-------------------------------|----------------------------|-------------------|----------------------------|---------------------------------|----------------------------|-----------------|----------------------------|
|                               | 2003                          |                            | 2002              |                            | 2003                            |                            | 2002            |                            |
|                               | Amount                        | % of Total Revenues        | Amount            | % of Total Revenues        | Amount                          | % of Total Revenues        | Amount          | % of Total Revenues        |
| (\$ in thousands)             |                               |                            |                   |                            |                                 |                            |                 |                            |
| <b>Revenues:</b>              |                               |                            |                   |                            |                                 |                            |                 |                            |
| Fuel sales                    | \$ 139,890                    | 65.1%                      | \$ 145,614        | 65.6%                      | \$ 74,901                       | 65.7%                      | 75,041          | 65.9%                      |
| FBOs                          | 45,983                        | 21.4                       | 47,708            | 21.5                       | 23,450                          | 20.6                       | 23,882          | 21.0                       |
| Cargo operations              | 19,577                        | 9.1                        | 16,444            | 7.4                        | 10,683                          | 9.4                        | 9,154           | 8.0                        |
| Government contract services  | 11,742                        | 5.5                        | 12,520            | 5.6                        | 5,915                           | 5.2                        | 6,314           | 5.5                        |
| Intercompany eliminations (2) | (2,292)                       | (1.1)                      | (429)             | (0.1)                      | (1,062)                         | (0.9)                      | (429)           | (0.4)                      |
| <b>Total Revenue</b>          | <b>\$ 214,900</b>             | <b>100.0%</b>              | <b>\$ 221,857</b> | <b>100.0%</b>              | <b>\$ 113,887</b>               | <b>100.0%</b>              | <b>113,962</b>  | <b>100.0%</b>              |
|                               | <b>Amount</b>                 | <b>% of Unit Revenues</b>  | <b>Amount</b>     | <b>% of Unit Revenues</b>  | <b>Amount</b>                   | <b>% of Unit Revenues</b>  | <b>Amount</b>   | <b>% of Unit Revenues</b>  |
| <b>Gross Margin(1):</b>       |                               |                            |                   |                            |                                 |                            |                 |                            |
| Fuel sales                    | \$ 3,300                      | 2.4%                       | \$ 3,071          | 2.1%                       | \$ 1,874                        | 2.5%                       | \$ 1,451        | 1.9%                       |
| FBOs                          | 6,288                         | 13.7                       | 5,914             | 12.4                       | 3,084                           | 13.2                       | 2,941           | 12.3                       |
| Cargo operations              | 1,296                         | 6.6                        | 1,704             | 10.4                       | 523                             | 4.9                        | 1,300           | 14.2                       |
| Government contract services  | 2,743                         | 23.4                       | 2,149             | 17.2                       | 1,431                           | 24.2                       | 1,196           | 18.9                       |
| <b>Total Gross Margin</b>     | <b>\$ 13,627</b>              | <b>6.3%</b>                | <b>\$ 12,838</b>  | <b>5.8%</b>                | <b>\$ 6,912</b>                 | <b>6.1%</b>                | <b>\$ 6,888</b> | <b>6.0%</b>                |
|                               | <b>Amount</b>                 | <b>% of Total Revenues</b> | <b>Amount</b>     | <b>% of Total Revenues</b> | <b>Amount</b>                   | <b>% of Total Revenues</b> | <b>Amount</b>   | <b>% of Total Revenues</b> |

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|  |            |        |            |        |            |        |          |        |
|--|------------|--------|------------|--------|------------|--------|----------|--------|
| Selling, general and administrative        | \$ 5,040   | 2.3%   | \$ 5,241   | 2.4%   | \$ 2,765   | 2.4%   | \$ 2,651 | 2.3%   |
| Provision for bad debts                    | 60         | 0.0    | 759        | 0.3    | (323)      | (0.3)  | 407      | 0.4    |
| Depreciation and amortization              | 4,279      | 2.0    | 4,049      | 1.8    | 2,108      | 1.9    | 1,998    | 1.8    |
| Interest expense and other                 | 4,280      | 2.0    | 2,865      | 1.3    | 1,899      | 1.7    | 1,533    | 1.3    |
| Hambro settlement costs                    | 1,799      | 1.0    |            |        | 1,799      | 1.6    |          |        |
| Debt extinguishment costs                  |            |        | 1,733      | 0.7    |            |        | 1,208    | 1.1    |
| Loss before income tax provision (benefit) | (1,831)    | (1.0)  | (1,809)    | (0.8)  | (1,336)    | (1.2)  | (909)    | (0.8)  |
| Income tax provision (benefit)             | (12)       | (1.0)% | (624)      | (0.3)  | 181        | (0.1)  | (313)    | (0.3)  |
| Net loss                                   | (1,819)    | (1.0)% | (1,185)    | (0.5)% | (1,517)    | (1.3)% | (596)    | (0.5)% |
| Accrued preferred stock dividends          | (19)       | (0.0)% |            |        | (9)        | (0.0)% |          |        |
| Net loss applicable to common stockholders | \$ (1,838) | (1.0)% | \$ (1,185) | (0.5)% | \$ (1,526) | (1.3)% | \$ (596) | (0.5)% |

(1) Gross margin as used here and throughout Management's Discussion includes certain selling, general and administrative costs which are charged directly to the operating units, but excludes depreciation and amortization expenses and selling, general and administrative expense.

**Three Months Ended December 31, 2003 Compared to December 31, 2002**

Revenue for the Company in the second quarter of fiscal 2004 was \$113,887 thousand, which is virtually unchanged from revenue of \$113,962 thousand reported for the second quarter of fiscal 2003. Gross margin increased by 0.4% to \$6,912 thousand in the second quarter of fiscal 2004 from \$6,888 thousand reported in the second quarter of fiscal 2003. The increase in gross margin reflected improved performances as discussed below at the Company's Fuel Sales, Air Centers, and Maytag Government Contract Services Operations segments off set by a decline in the Air Cargo Operating Segment.

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MercFuel, the Company's fuel sales business, generated revenue of \$74,901 thousand in the current period, a decrease of \$140 thousand or 1.9% from last year's revenue of \$75,041 thousand. The decrease in revenue was primarily due to lower sales volume offset by higher average fuel sales prices. Fuel sales volume was 70.8 million gallons in the second quarter of fiscal 2004, a decrease of 7.3 million gallons from the same period of fiscal 2003 resulting in a reduction in sales revenue of \$7.0 million. The decline in sales volume is due to the cessation of business by National Airlines, Inc. (National), a customer of MercFuel since May 1999, on November 6, 2002. Sales volume to National in the second quarter of fiscal 2003 was 8.0 million gallons providing revenue of \$7.2 million. Excluding the sales volume to National from MercFuel's total sales volume in the second quarter of fiscal 2003, second quarter 2004 sales volume increased 0.7 million gallons, or 1.0%, from last year. The average sales price in the second quarter of fiscal 2004 was \$1.057 per gallon, an increase of \$0.097 per gallon from the same period of last year resulting in an increase in revenue of \$6.8 million due to higher average sales prices. The higher average sales price is due to higher worldwide petroleum prices. MercFuel's revenues represented 65.7% of the Company's total revenue in the current period compared to 65.9% of the Company's total revenue in the comparable prior year quarter. MercFuel's gross margin from fuel sales was \$1,874 thousand, or \$0.043 per gallon, in the current period compared with \$1,421 thousand, or \$0.035 per gallon, in the same period last year. The increase in gross margin was primarily due to higher realized margins for fuel sales in the Commercial Airline market, where the average margin per gallon increased to \$0.038 per gallon in the second quarter of fiscal 2004 from \$0.028 per gallon last year.

The Company's Air Centers business segment had revenue of \$23,450 thousand in the second quarter of fiscal year 2004, a decrease of \$432 thousand or 1.8% from last year's second quarter revenue of \$23,882 thousand. The revenue decrease was mainly due to lower revenue of \$0.5 million in maintenance activities in the Air Center operations. The Air Centers' aviation fuel sales volume in the second quarter of fiscal 2004 was 8.0 million gallons with an average sales price of \$1.94 per gallon as compared to last year's second quarter sales volume of 8.4 million gallons with an average sales price of \$1.82 per gallon. The higher average sales price was mainly due to higher worldwide petroleum prices. Air Centers' gross margin increased by \$143 thousand or 4.9% in the current period to \$3,084 thousand from \$2,941 thousand due to lower expenses of \$146 thousand resulting from the Company's cost reduction initiatives in fiscal 2003.

The Company's Air Cargo operations had revenue of \$10,683 thousand in the second quarter of fiscal 2004, an increase of \$1,529 thousand or 16.7% from revenue of \$9,154 thousand in the second quarter of fiscal 2003. The increase in revenue is mainly due to improvements in cargo management of \$0.1 million and cargo marketing services of \$2.0 million offset by a decline in cargo handling of \$0.5 million. The increase in cargo marketing services represents increased activity generated by the Mercury World Cargo division, which sells Cargo capacity under Mercury's own airway bill. Gross margin from Air Cargo operations in the current period decreased by \$777 thousand, or 59.8%, to \$523 thousand from \$1,300 thousand in the year ago period due primarily to the accrual of employee severance costs of \$0.3 million in the second quarter of fiscal 2004.

The Company's Government Contract Services segment had revenue of \$5,915 thousand in the second quarter of fiscal 2004, a decrease of \$399 thousand or 6.3% from revenue of \$6,314 thousand in the second quarter of fiscal 2003. The revenue decrease is primarily due to the decreased revenue from the Weather Data Services contracts in the amount of \$0.2 million and the loss of one refueling contract, which generated revenue of \$0.2 million last year. Gross margin in the current period increased by \$235 thousand or 19.6% to \$1,431 thousand from \$1,146 thousand last year due to recovery of a wage determination on the Westover contract.

Selling, general and administrative expenses in the current quarter increased by \$114 thousand, or 4.3%, to \$2,765 thousand from \$2,651 thousand in last fiscal year's second quarter primarily due to higher professional fees associated with the re-audit of the Company's financial statements for fiscal 2002 and 2001 of \$311 thousand and higher legal fees associated with the Hambro Settlement of \$138 thousand.

The Company realized a benefit of \$323 thousand for bad debts in the second quarter of fiscal 2004 as a result of better than expected customer collections experience over the past three quarters resulting in the reversal of previously established bad debt reserves as compared to bad debt expense of \$407 thousand for the second quarter of fiscal 2003.

Depreciation and amortization expense was \$2,108 thousand in the current period compared to \$1,998 thousand a year ago.

Interest expense and other was \$1,899 thousand in the second quarter of fiscal 2004, an increase of \$366 thousand from the same period last year. The increase was due to the accrual in the second quarter of fiscal 2004 of \$288 thousand for the debt premiums and increased debt service costs associated with the Company's Senior Secured Credit Facility entered into on December 30, 2002 as compared to the debt service costs associated with the previous Senior Secured Credit Facility.



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The Company recognized settlement expense of \$1,799 thousand in the second quarter of fiscal 2004 associated with the Hambro Settlement. The settlement expense represents the difference between the face value of the Hambro Notes and the trading value of the shares of common stock acquired by the Company on the settlement date. See further discussion of the settlement in the discussion of liquidity and capital resources which follows.

In fiscal 2003, the company wrote-off unamortized deferred debt issuance costs of \$1,208 thousand in the second quarter of fiscal 2003 due to the Company's debt restructuring in December 2002.

The settlement cost of \$1,799 thousand recognized by the Company in the second quarter of fiscal 2004 is not deductible in determining taxable income resulting in a permanent book to tax difference. As a result, the Company's taxable income is higher than the Company's loss before income tax provision by \$1,799 thousand increasing the Company's income tax provision by \$702 thousand to \$181 thousand.

***Six Months Ended December 31, 2003 Compared to December 31, 2002***

Revenue for the Company for the first six months of fiscal 2004 was \$214,900 thousand, which decreased by 3.1% from revenue of \$221,857 thousand reported for the first six months of fiscal 2003. The decrease in revenue is due primarily to lower MercFuel revenue of \$5,724 thousand. Gross margin increased by 6.2% to \$13,627 thousand in the first six months of fiscal 2004 from \$12,838 thousand reported in the first six months of fiscal 2003. The increase in gross margin is due to improved performances at the Company's Air Centers, MercFuel and Maytag Government Contract Services Operations segments.

MercFuel, the Company's fuel sales business, generated revenue of \$139,890 thousand in the current period, a decrease of \$5,724 thousand or 3.9% from last year's revenue of \$145,614 thousand. The decrease in revenue was primarily due to lower sales volume partially offset by higher average fuel sales prices. Fuel sales volume was 135.1 million gallons in the first six months of fiscal 2004, a decrease of 23.1 million gallons from the same period of fiscal 2003 resulting in a reduction in sales revenue of \$21.3 million. The decline in sales volume is due to the cessation of business by National Airlines, Inc.'s (National), a customer of MercFuel since May 1999, on November 6, 2002. Sales volume to National in fiscal 2003, through November 6, 2003, was 28.9 million gallons, resulting in revenue of \$24.7 million. Excluding the sales volume to National from MercFuel's total sales volume for the first half of fiscal 2003, first half 2004 sales volume increased 5.8 million gallons, or 4.5% from last year. The average sales price in the first six months of fiscal 2004 was \$1.04 per gallon, an increase of \$0.115 per gallon from the same period of last year resulting in an increase in revenue of \$15.3 million due to higher average sales prices. The higher average sales price is due to higher worldwide petroleum prices. MercFuel's revenues represented 65.1% of the Company's total revenue in the current period compared to 65.6% of revenue in the comparable prior year. MercFuel's gross margin was \$3,300 thousand in the current period compared with \$3,071 thousand in the same period last year, of which \$0.4 million was generated from sales to National. The average gross margin per gallon sold in the first six months of fiscal year 2004 was \$0.0387 per gallon as compared to \$0.0341 for the same period last year.

The Company's Air Centers business segment had revenue of \$45,983 thousand in the first six months of fiscal 2004, a decrease of \$1,725 thousand or 3.6% from last year's first six months revenue of \$47,708 thousand. The revenue decrease was mainly due to lower revenue of \$1.5 million in maintenance activities in the Air Center operations. The Air Centers' aviation fuel sales volume in the first half of fiscal 2004 was 15.7 million gallons with an average sales price of \$1.92 per gallon as compared to last year's first half sales volume of 17.1 million gallons with an average sales price of \$1.76 per gallon. The higher average sales price was mainly due to slightly higher worldwide petroleum prices. Air Center's gross margin increased by \$374 thousand or 6.3% in the current period to \$6,288 thousand from \$5,914 thousand last year due to the Company's cost reduction initiatives implemented in fiscal 2003.

The Company's Air Cargo operations had revenue of \$19,577 thousand in the first six months of fiscal 2004, an increase of \$3,133 thousand or 19.1% from revenue of \$16,444 thousand in the first six months of fiscal 2003. The increase in revenue is mainly due to improvements in cargo management of \$0.3 million and cargo marketing services of \$2.9 million. Gross margin from Air Cargo operations in the current period decreased by \$408 thousand, or 23.9%, to \$1,296 thousand from \$1,704 thousand in the year ago period due primarily to the accrual of employee severance cost of \$0.3 million in fiscal 2004.

The Company's Government Contract Services segment had revenue of \$11,742 thousand in the first six months of fiscal 2004, a decrease of \$778 thousand or 6.2% from revenue of \$12,520 thousand in the first six months of fiscal 2003. The revenue decrease is primarily due to decreased revenue from Weather Data Services contracts in the amount of \$0.5 million and the loss of one refueling contract, which generated revenue of \$0.5 million last year. Gross margin in the current period increased by \$593 thousand or 27.6% to \$2,743 thousand from \$2,149 thousand last year due to the recovery of a wage determination in fiscal 2004 for the Company's

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Westover contract and the establishment of a legal reserve for settlement of a labor dispute on the Company's Patrick Air Force Base contract in fiscal 2003.

Selling, general and administrative expenses for the year decreased by \$201 thousand, or 3.9%, to \$5,040 thousand from \$5,241 thousand in last year's first six months primarily due to a \$318 thousand expense relating to the extension of the term for certain stock options in the prior year.

Provision for bad debts was \$60 thousand in the current period, compared to \$759 thousand from the prior year. The reduction reflects better than expected customer collections experience over the past three quarters resulting in the reversal during the second quarter of fiscal year 2004 of \$323,000 in previously recognized bad debt expense.

Depreciation and amortization expense was \$4,279 thousand in the current period compared to \$4,049 thousand a year ago.

Interest expense and other was \$4,280 thousand in the first six months of fiscal 2004, an increase of \$1,415 thousand from the same period last year, due to the accrual in fiscal 2004 of \$1,150 thousand for the debt premiums and the increased debt servicing costs associated with the Company's Senior Secured Credit Facility entered into on December 30, 2002 as compared with the Company's previous Senior Secured Credit Facility.

The Company recognized settlement expense of \$1,799 thousand in the second quarter of fiscal 2004 associated with the Hambro Settlement. The settlement expense represents the difference between the face value of the Hambro Notes and the trading value of the shares of common stock acquired by the Company on the settlement date. See further discussion of the settlement in the discussion of liquidity and capital resources which follows.

The Company wrote off unamortized deferred financing costs of \$1,733 thousand in the first six months of fiscal 2003 due to the Company's debt restructuring in December 2002.

The settlement cost of \$1,799 thousand recognized by the Company in the second quarter of fiscal 2004 is not deductible in determining taxable income resulting in a permanent book to tax difference. As a result, the Company's taxable loss is lower than the book loss before income tax benefit for the six month period ended December 31, 2003 by \$1,799 thousand reducing the Company's income tax benefit in fiscal 2004 by \$702 thousand to \$12 thousand.

## **Liquidity and Capital Resources**

As of December 31, 2003, the Company's cash and cash equivalents were \$3.4 million, an increase of \$0.6 million as compared to cash and cash equivalents of \$2.8 million as of June 30, 2003.

Cash provided by operating activities for the six month period ended December 31, 2003 was \$4.5 million as compared to cash used for operating activities of \$1.3 million in the first half of fiscal 2003. The change in operating assets and liabilities for the first six months of fiscal 2004 resulted in an increase of \$1.1 million as compared to a decrease of \$8.1 million in the first six months of fiscal 2003, which reflects a payment of \$4.5 million for income taxes primarily due to the sale of the Bedford FBO.

During the first six months of fiscal 2004, the Company used \$1.8 million in investing activities primarily due to additions to property, equipment and leaseholds of \$2.6 million, offset by a \$0.8 million reduction in notes receivable and other assets. This compares to cash used in investing activities of \$0.8 million during the first six months of fiscal 2003 resulting from the reduction in restricted cash of \$3.7 million, established to pay for the estimated income tax obligation from the sale of the Bedford FBO, partially offset by capital expenditures of \$3.6 million. The Company's financing activities resulted in a net cash outlay of \$2.3 million during the first six months primarily associated with the scheduled repayment of debt, as compared to net cash generated from financing activities for the first six months of fiscal 2003 of \$1.0 million.

On December 30, 2002, the Company entered into a loan and security agreement with Foothill Capital Corporation (Foothill), now known as Wells Fargo Foothill, a division of Wells Fargo Bank (the Facility), as agent for the lenders' party thereto, refinancing its senior collateralized credit facilities for a five-year term. In addition, the Company and J.H. Whitney Co. Mezzanine Fund entered into agreements amending the terms of the subordinated note (the Whitney Note), which will mature on December 31, 2005. The initial funding from the facility and the amendments to the subordinated note was completed on December 30, 2002.

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The Company's senior secured credit facility ( Facility ) consists of up to \$42.5 million in revolving and term loans. The term loan is currently for an amount equal to \$9.5 million, while the revolving loan is for an amount not to exceed 85% of Eligible Accounts Receivable (as defined in the loan agreement), subject to certain limitations. The term loan is payable in \$1.0 million installments each April 1 and October 1, beginning April 1, 2003 and in \$0.5 million installments each July 1 and December 31, until paid in full. Amounts repaid under the term loan increase the maximum availability under the revolving loan. The Facility also provides for the issuance of certain letters of credit. The terms of the Facility require that the Company maintain a minimum availability on the revolving line of credit of \$2.5 million. As of December 31, 2003, the Company had \$7.1 million of availability on the revolving line of credit. The amount of available revolving credit line fluctuates on a daily basis dependent upon the amount of Eligible Receivables, the amount of letters of credit outstanding and the amount of outstanding cash borrowings against the revolving credit facility.

The amended Whitney Note was in the form of a \$24.0 million Senior Subordinated 12% Note (the Note ) with detachable warrants to purchase 251,563 shares of the Company's common stock exercisable through September 9, 2006 at \$6.10 per share as adjusted for the one-for-two stock split in July 2003. The warrant exercise price was reduced from \$11.00 per share. The Note is collateralized by the Company's assets, subordinate to Foothill's interest. Warrants to purchase an additional 5% of the Company's common stock, exercisable for nominal consideration, would have been issuable if the principal amount of the Note was not prepaid by December 31, 2003. Warrants to purchase a second 5% of the Company's common stock, exercisable for nominal consideration, along with an additional note in the original principal amount of \$5 million would also have been issued if the outstanding principal amount of the Note was greater than \$12 million after December 31, 2003. However, on October 28, 2003 the Company announced that Allied had acquired the Note from Whitney and waived the provisions for the additional warrants equivalent to 10% of the Company's outstanding common stock and the additional \$5 million note. Beginning January 2004 and continuing through June 2004, the interest rate will increase by 1% per annum each month up to a maximum rate of 18%. As of December 31, 2003, the Company had accrued \$2,875 thousand associated with the Note premiums, of which \$1,150 thousand was accrued during the first four months of fiscal 2004, up until the time that Allied acquired the Note from J.H. Whitney Co. The amended note contains similar covenants as the original Note, including covenants that, among other matters, limit senior indebtedness, the payment of dividends, and the disposition of assets. The revised covenants also include minimum EBITDA requirements and capital expenditure limitations.

The Facility may be terminated on December 23, 2005, if the Note is not paid in full or refinanced, on terms acceptable to Foothill, prior to October 31, 2005. The Facility is collateralized by substantially all of the assets of the Company and its subsidiaries. The Facility contains provisions that require the maintenance of certain financial ratios including minimum EBITDA levels, minimum fixed charge coverage ratios, and maximum annual capital expenditure levels. In addition, under the Facility, the Company is prohibited from paying non-intercompany cash dividends.

On October 28, 2003, the Company also announced the FBO Sale, for which closing is, among other things, contingent upon: 1) stockholder approval; 2) the completion of due diligence; and 3) regulatory agencies' approvals and consents. The proceeds from the FBO Sale are subject to the establishment of an escrow account in the amount of \$8.3 million to be distributed at the earlier of the award of a long term lease to Allied for the FBO at the Hartsfield Airport or in five equal annual installment payments starting at the first anniversary date of the close of the FBO Sale if the Air Centers' lease for the Hartsfield FBO is not terminated earlier, reimbursement for certain FBO capital expenditures made by the Company, minimum working capital amounts at closing and other customary terms and conditions. The Company has received consent for the FBO Sale from its Senior Lenders. In accordance with the terms of the definitive agreement, as amended, the FBO Sale is to close on or before May 14, 2004.

On December 5, 2003, as amended on February 16, 2004, the Company and its lenders under the Senior Secured Credit Facility executed the Fifth Amendment to the Loan and Security Agreement and Forebearance Agreement (the Forebearance Agreement ). Among other things, the Company requested the lenders and the lenders agreed to forebear from exercising their rights and remedies under the Senior Secured Credit Facility for the following events of default, as defined in the Loan and Security Agreement: (1) the Company's failure to deliver its annual audited financial statements for fiscal 2003 within the prescribed time-frame allowed; (2) the formation of a subsidiary, Mercury Air Center Long Beach, without the prior consent of the lenders; (3) the Company's failure to deliver supplemental schedules to J. H. Whitney as required under the terms of the \$24 million Senior Secured 12% Note; and (4) the Company's failure to achieve the EBITDA financial covenant for the twelve month period ended December 31, 2003. The Forebearance Agreement, as amended, states that the lenders agree, for a limited time but no later than April 14, 2004, to forebear from exercising their rights and remedies under the Senior Secured Credit Facility with respect to the events of default noted above. The Company and Allied have amended the Definitive Agreement whereby the closing date of the FBO Sale is now on a date on or prior to May 14, 2004. If the FBO Sale does not close by April 14, 2004, the Company and the Lenders will need to amend the FBO Sale closing date in the Forebearance Agreement or the Lenders would have the right to exercise their rights and remedies under the Senior Secured Credit Facility with respect to the events of default noted above.

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On December 12, 2003, the Company entered into a settlement agreement (the Hambro Settlement) relating to litigation with J O Hambro Capital Management and certain of its affiliates and private clients ( J O Hambro ) whereby the Company issued three promissory notes for an aggregate principle amount of \$3,586,000 (the Hambro Notes ) in exchange for the following, among other things: (1) the release of certain claims by J O Hambro; (2) the Company s agreement to dismiss litigation against J O Hambro; (3) the Company s agreement not to institute certain litigation against J O Hambro and certain other parties; (4) reimbursement of certain costs associated with the pending litigation and the defense preparation for anticipated litigation between the parties; and (5) the purchase of 343,600 shares of the Company s common stock in exchange for the Hambro Notes. The Hambro Notes: 1) are subordinated to the Senior Secured Credit Facility and to the Senior Subordinated Note; 2) are due on the earlier of (a) the ninetieth day following payment in full of the Senior Secured Credit Facility and the termination of commitments for the Senior Secured Lender to provide financing under the Senior Secured Credit Facility; or (b) March 31, 2006, provided that if the Senior Secured Credit Facility Matures on December 31, 2007 then such date shall be March 31, 2008; and 3) bear and accrue interest at the rate of 12% per annum commencing on December 31, 2003 but will increase to 16% per annum for any amount of unpaid principal after June 30, 2004.

At the close of the FBO Sale, the Company estimates gross sales proceeds of \$73.1 million. The Company intends to use these proceeds to: 1) prepay the outstanding principal amount on the Senior Secured Term Loan of \$10 million; 2) repay all outstanding cash advances on the Revolving Line of Credit; 3) pay all accrued interest, fees and expenses associated with the Senior Secured Credit Facility; 4) provide cash collateral for the outstanding Letters of Credit of approximately \$16.0 million; 5) prepay the outstanding principal amount on the Allied Note; 6) pay all accrued interest, fees and expenses associated with the Allied Note; 7) establish an escrow account for the FBO at the Hartsfield Airport in the amount of \$8.3 million; 8) repay the outstanding principal amount due on the J. O. Hambro Note of \$3.6 million; 9) repay all accrued interest on the Hambro Notes; and 10) pay all commissions, fees and expenses associated with the sale transaction. After settlement of the all of the obligations noted above, the Company estimates that the transaction will result in surplus cash proceeds of approximately \$5.6 million, of which an estimated \$1.5 million will be required to settle the Company s current income tax obligation associated with the FBO Sale although the exact amount of the surplus cash proceeds will be dependent upon many factors including, but not limited to, the date of closing.

The Company is currently evaluating new credit facilities to support the Company s expansion of its remaining three business lines and to support the Company s Letters of Credit requirements thereby releasing the cash collateral of approximately \$16 million to be used for working capital requirements and general corporate purposes.

In January 2004 the Company s wholly owned subsidiary, Maytag Aircraft Corporation, located in Colorado Springs, Colorado, was awarded the United States Air Mobility Command (AMC) contract to provide Air Terminal and Ground Handling Services at Kuwait International Airport. Under the terms of the contract, Maytag Aircraft Corporation will provide air terminal and ground handling services for the Air Mobility Command, working U.S. Government owned or operated aircraft and U.S. Government sponsored foreign aircraft requiring such services at Kuwait International Airport/Al Mubarek Air Base. This contract is effective April 1, 2004 through September 30, 2004 with four one-year option periods making the full term of this \$18 million contract effective through September 30, 2008. This contract represents a continuum of air terminal and ground handling services provided by Maytag Aircraft Corporation to AMC since August of 2000. The services include operating the air terminal operations center (information control, load planning, capability forecasting, and ramp coordination), and providing aircraft services (cargo processing, aircraft loading and unloading, cleaning, and catering), ground services (marshalling, material handling, baggage handling, and all related connect/disconnect services), passenger services, information systems, and equipment maintenance.

### **Critical Accounting Policies**

Management s beliefs regarding critical accounting policies have not changed significantly from those discussed in Item 7 of the Company s Annual Report on Form 10-K for the fiscal year ended June 30, 2003.

### **Item 3. Quantitative and Qualitative Disclosure About Market Risk**

There has been no material change during the six months ended December 31, 2003 from the disclosures regarding market risk presented in the Company s Annual Report on Form 10-K for the fiscal year ended June 30, 2003.

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**Item 4. Controls and Procedures**

**Evaluation of Disclosure Controls and Procedures**

Based on evaluations as of December 31, 2003, our principal executive officer and principal financial officer, with the participation of our management team, have concluded that our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act) are effective to ensure that information required to be disclosed by us in reports that we file or submit under the Securities Exchange Act is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the SEC.

**Changes in Internal Controls**

There were no significant changes in our internal controls or in other factors that could significantly affect these internal controls subsequent to the date of their most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

**Forward-Looking Statements**

Statements contained in this Quarterly Report on Form 10-Q 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 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.

**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings**

The Company is 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 material effect on its consolidated financial statements. Reference is made to the Company's Quarterly Report on Form 10-Q for the period ended September 30, 2003 for additional legal matters with respect to which no material developments have occurred in the current quarter.

**Table of Contents****Item 2. Change in Securities, Use of Proceeds, and Issuer Purchases of Equity****Securities****ISSUER PURCHASES OF EQUITY SECURITIES**

| <b>Period</b>   | <b>(a) Total Number of Shares (or Units) Purchased</b> | <b>(b) Average Price Paid per Share (or Unit)</b> | <b>(c) Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs</b> | <b>(d) Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs</b> |
|---|--|---|--|--|
| Month #1<br>October 1, 2003<br>to<br>October 31, 2003   | 0  | N/A   | N/A  | N/A  |
| Month #2<br>November 1, 2003<br>to<br>November 30, 2003 | 0  | N/A   | N/A  | N/A  |
| Month #3<br>December 1, 2003<br>to<br>December 31, 2003 | 343,600  | \$ 10.44(1)                                       | 343,600(2)   | 0  |
| <b>Total</b>  |  |   |  |  |

- (1) Represents principal amount of Hambro Notes, divided by number of shares of Mercury common stock purchased by the Company. The Hambro Notes were issued in exchange for the following, among other things: (1) the release of certain claims by J O Hambro; (2) the Company's agreement to dismiss litigation against J O Hambro; (3) the Company's agreement not to institute certain litigation against J O Hambro and certain other parties; (4) reimbursement of certain costs associated with the pending litigation and the preparation for anticipated litigation between the parties; and (5) the issuance of 343,600 shares of Mercury common stock.
- (2) This transaction was publicly reported on Form 8-K dated December 15, 2003. No other shares will be purchased pursuant to this transaction.

**Item 3. Default Upon Senior Securities**

On December 5, 2003, the Company and its Lenders under the Senior Secured Credit Facility, executed the Fifth Amendment to Loan and Security Agreement and Forebearance Agreement (the "Forebearance Agreement"). In accordance with the terms of the Forebearance Agreement, as amended on February 16, 2004, the Lenders agreed to forebear from exercising their rights and remedies under the Senior Secured Credit Facility for the following events of default, as defined in the Loan and Security Agreement: (1) the Company's failure to deliver its annual audited financial statements for fiscal year 2003 within the prescribed time-frame allowed; (2) the formation of a subsidiary, Mercury Air Center Long Beach, without the prior consent of the Lenders; (3) the Company's failure to deliver supplemental schedules to J. H. Whitney as required under the terms of the \$24 million Senior Secured 12% Note; and (4) the Company's failure to achieve the EBITDA financial covenant for the twelve month period ended December 31, 2003. The Forebearance Agreement, as amended, states that the Lenders agree, for a limited time but no later than April 14, 2004, to forebear from exercising their rights and remedies under the Senior Secured Credit Facility with respect to the events of default noted above. The Company and Allied have amended the Definitive Agreement whereby the closing date of the FBO Sale is to occur on or before May 14, 2004. If the FBO Sale does not close by April 14, 2004, the Company and the Lenders will need to amend the FBO Sale closing date in the Forebearance Agreement or the Lenders would have the right to exercise their rights and remedies under the Senior

Secured Credit Facility with respect to the events of default noted above.

**Item 4. *Submission of Matters to a Vote of Security Holders***

None

**Item 5. *Other Information***

None

**Table of Contents****Item 6. Exhibits and Exhibit List****(a) Exhibits and Reports on Form 8-K:**

| Exhibit<br>No. | Description  |
|----------------|--|
| 2.1            | Agreement and Plan of Merger adopted January 9, 2001.(17)  |
| 2.2            | Certificate of Merger.(17)   |
| 2.3            | Stock Purchase Agreement Dated as of October 28, 2003. By and Among Allied Capital Corporation, Mercury Air Centers, Inc. and Mercury Air Group, Inc.(28)  |
| 3.1            | Certificate of Incorporation.(17)  |
| 3.2            | Amended and Restated Bylaws of Mercury Air Group, Inc. adopted December 7, 2002.(25)   |
| 3.3            | Certificate of Designations of Series A 8% Cumulative Convertible Preferred Stock.(27)   |
| 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.(18)  |
| 4.6            | Waiver Agreement dated as of September 25, 2001 among Mercury Air Group, Inc. and J.H. Whitney Mezzanine Fund, L.P.(18)  |
| 4.7            | Amendment No. 2 dated as of September 30, 2001 by and between J.H. Whitney Mezzanine Fund, L.P. and Mercury Air Group, Inc. to the Securities Purchase Agreement.(19)  |
| 4.8            | Waiver Agreement dated as of November 26, 2001 among Mercury Air Group, Inc. and J.H. Whitney Mezzanine, L.P.(21)  |
| 4.9            | Waiver Agreement dated as of December 21, 2001 among Mercury Air Group, Inc. and J.H. Whitney Mezzanine, L.P.(21)  |
| 4.10           | Waiver Agreement dated as of June 26, 2002 among Mercury Air Group, Inc. and J.H. Whitney Mezzanine, L.P.(24)  |
| 4.11           | Amendment No. 3 to Securities Purchase Agreement by and between Mercury Air Group, Inc. and J.H. Whitney Mezzanine Fund, L.P. dated as of December 30, 2002.(26)   |
| 4.12           | Amended and Restated J.H. Whitney Mezzanine Fund, L.P. Warrant dated September 10, 1999.(26)   |
| 4.13           | Amended and Restated J.H. Whitney Mezzanine Fund, L.P. Senior Subordinated Promissory Note dated September 10, 1999.(26)   |
| 4.14           | Security Agreement by and between Mercury Air Group, Inc. and each of its subsidiaries hereto as Obligors and J.H. Whitney Mezzanine Fund, L.P. as the Lenders, dated as of December 30, 2002.(26)   |
| 4.15           | Subordination Agreement among J.H. Whitney Mezzanine Fund, L.P. Foothill Capital Corporation, as Agent and Mercury Air Group, Inc. and certain of its subsidiaries signatory thereto, dated as of December 30, 2002.(26)   |
| 4.16           | Loan and Security Agreement by and among Foothill Capital Corporation and Mercury Air Group, Inc. and certain subsidiaries signatory thereto, dated as of December 30, 2002.(26)   |
| 4.17           | First Amendment to Loan and Security Agreement by and among Foothill Capital Corporation and Mercury Air Group, Inc. and certain of its subsidiaries, dated March 12, 2003.(30)  |
| 4.18           | Second Amendment to Loan and Security Agreement by and among Foothill Capital Corporation and Mercury Air Group, Inc. and certain of its subsidiaries, dated March 31, 2003.(30)   |
| 4.19           | Third Amendment to Loan and Security Agreement by and among Foothill Capital Corporation and Mercury Air Group, Inc. and certain of its subsidiaries, dated July 16, 2003.(30)   |
| 4.20           | Fourth Amendment to Loan and Security Agreement by and among Foothill Capital Corporation and Mercury Air Group, Inc. and certain of its subsidiaries, dated August 1, 2003.(30)   |
| 4.21           | Amendment No. 4 to Securities Purchase Agreement by and between Mercury Air Group, Inc. and Allied Capital Corporation, as Assignee of J.H. Whitney Mezzanine Fund, L.P. dated as of October 28, 2003(28)  |
| 4.22           | Assignment of Note dated as of October 28, 2003 between Allied Capital Corporation and J.H. Whitney Mezzanine Fund, L.P.(28)   |
| 4.23           | Second Amended and Restated Allied Capital Corporation 12% Senior Subordinated Promissory Note dated September 10, 1999(28)  |
| 4.24           | Second Amended and Restated Allied Capital Corporation Warrant dated October 28, 2003(28)  |
| 4.25           | Securities Purchase Agreement dated as of October 28, 2003 by and among J.H. Whitney Mezzanine Fund, L.P. and J.H.   |





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|-------|--|
|       | Whitney Mezzanine Debt Fund, L.P., Allied Capital Corporation and Mercury Air Group, Inc.(28)  |
| 4.26  | Second Amended and Restated J.H. Whitney Mezzanine Fund, L.P. Warrant dated October 28, 2003(28)   |
| 4.27  | Fifth Amendment to Security and Loan Agreement and Forbearance Agreement dated as of December 5, 2003 by and among Wells Fargo Foothill, Mercury Air Group, Inc. and certain of its subsidiaries.  |
| 4.28  | Amendment to Stock Purchase Agreement by and Among Allied Capital Corporation, Mercury Air Centers, Inc. and Mercury Air Group, Inc. dated as of December 10, 2003.  |
| 4.29  | Amendment to Stock Purchase Agreement by and Among Allied Capital Corporation, Mercury Air Centers, Inc. and Mercury Air Group, Inc. dated as of January 14, 2004.   |
| 10.1  | Mercury Air Group, Inc. s 1990 Long-Term Incentive Plan.(4)*   |
| 10.2  | Mercury Air Group, Inc. s 1990 Directors Stock Option Plan.(1)*  |
| 10.3  | Memorandum Dated September 15, 1997 regarding Summary of Officer Life Insurance Policies with Benefits Payable to Officers or Their Designated Beneficiaries.(8)*  |
| 10.4  | Non-Qualified Stock Option Agreement dated March 21, 1996, by and between Frederick H. Kopko and Mercury Air Group, Inc.(6)*   |
| 10.5  | Mercury Air Group, Inc. s 1998 Long-Term Incentive Plan.(10)*  |
| 10.6  | Mercury Air Group, Inc. s 1998 Directors Stock Option Plan.(10)*   |
| 10.7  | 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)   |
| 10.8  | First Amendment to Revolving Credit and Term Loan Agreement dated as of September 10, 1999.(14)  |
| 10.9  | Second Amendment to Revolving Credit and Term Loan Agreement dated as of March 31, 2000.(14)   |
| 10.10 | Third Amendment, Waiver and Consent to Revolving Credit and Term Loan Agreement dated as of August 11, 2000.(14)   |
| 10.11 | The Company s 401(k) Plan consisting of CNA Trust Corporation. Regional Prototype Defined Contribution Plan and Trust and Adoption Agreement.(14)*   |
| 10.12 | Employment Agreement dated July 31, 2000 between the Company and Dr. Philip J. Fagan.(15)*   |
| 10.13 | Fourth Amendment to Revolving Credit and Term Loan Agreement dated as of November 14, 2000.(16)  |
| 10.14 | Amendment No. 1 to Mercury Air Group, Inc. 1998 Long-Term Incentive Option Plan as of August 22, 2000.(16)*  |
| 10.15 | Amendment No. 1 to Mercury Air Group, Inc. 1998 Directors Stock Option Plan as of August 22, 2000.(16)*  |
| 10.16 | Limited Waiver letter Agreement to Revolving Credit and Term Loan Agreement dated as of September 21, 2001.(18)  |
| 10.17 | Fifth Amendment to Revolving Credit and Term loan Agreement dated as of September 21, 2001.(18)  |
| 10.18 | Limited Consent letter Agreement to Revolving Credit and Term Loan Agreement dated as of September 30, 2001.(19)   |
| 10.20 | Limited waiver and Consent to Revolving Credit and Term Loan Agreement dated as of December 31, 2001.(21)  |
| 10.21 | 2002 Management Stock Purchase Plan.(22)   |
| 10.22 | Amended and Restated Employment Agreement dated May 22, 2002 between Mercury Air Group, Inc. and Joseph A. Czyzyk.(22)*  |
| 10.23 | Employment Agreement dated May 22, 2002 between Mercury Air Group, Inc. and Wayne J. Lovett(22)*   |
| 10.24 | Employment Agreement dated May 22, 2002 between Mercury Air Group, Inc. and John Enticknap(22)*  |
| 10.25 | Employment Agreement dated May 22, 2002 between Mercury Air Group, Inc. and Mark Coleman(22)*  |
| 10.26 | Employment Agreement dated May 22, 2002 between Mercury Air Group, Inc. and Steven S. Antonoff(22)*  |
| 10.27 | Employment Agreement dated May 22, 2002 between Mercury Air Group, Inc. and Robert Schlax(22)*   |
| 10.28 | Limited waiver and Consent to Revolving Credit and Term Loan Agreement dated as of June 27, 2002.(24)  |
| 10.29 | Sale-Leaseback agreement made by and between CFK Realty Partners, LLC and Mercury Air Group, Inc. dated December 15, 2001.(24)   |
| 10.30 | Amendment to Sale-Leaseback agreement made by and between CFK Realty Partners, LLC and Mercury Air Group, Inc.(24)   |
| 10.31 | Promissory Note by CFK Partners, LLC in favor of Mercury Air Group, Inc.(24)   |
| 10.32 | Limited Waiver and Consent to Revolving Credit and Term Loan Agreement dated as June 27, 2002.(24)   |
| 10.33 | Amendment No. 1 to Amended and Restated Employment Agreement dated May 22, 2002 between Mercury Air Group, Inc. and Joseph A. Czyzyk.*(24)   |
| 10.34 | Lease dated December 31, 2001 by and between CFK Realty Partners, LLC. and Mercury Air Group, Inc.(30)   |
| 10.35 | Settlement Agreement dated December 12, 2003 by and among (i) J O Hambro Capital Management Group Limited, (ii) J O Hambro Capital Management Limited, (iii) American Opportunity Trust PLC, (iv) The Trident North Atlantic Fund, and (v) Mercury Air Group, Inc.(29) |
| 31.1  | Section 302 Certification of Chief Executive Officer   |
| 31.2  | Section 302 Certification of Chief Financial Officer   |
| 32.1  | Section 906 Certification of Chief Executive Officer   |
| 32.2  | Section 906 Certification of Chief Financial Officer   |
| 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)  |



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- \* 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 Stockholders 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 Stockholders.
  - (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 are 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 Stockholders and is incorporated herein by reference.
  - (11) 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, 1999 and are 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 are incorporated herein by reference.
  - (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 are 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, 2000 and are 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 are incorporated herein by reference.
  - (18) 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, 2001 and are incorporated herein by reference.

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- (19) 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, 2001 and are incorporated herein by reference.
- (20) Such document was previously filed as Appendix A to the Company's Proxy Statement for the November 7, 2001 Annual Meeting of Stockholders and is incorporated herein by reference.
- (21) 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 are incorporated herein by reference.
- (22) Such document was previously filed as an Exhibit to the Company's Current Report on Form 8-K on June 5, 2002 and is incorporated herein by reference.
- (23) Such document was previously filed as an Exhibit to the Company's Current Report on Form 8-K on July 11, 2002 and is incorporated herein by reference.
- (24) 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, 2002 and are incorporated herein by reference.
- (25) Such document was previously filed as an Exhibit to the Company's Current Report on Form 8-K on December 7, 2002 and is incorporated herein by reference.
- (26) Such document was previously filed as an Exhibit to the Company's Current Report on Form 8-K on December 30, 2002 and is incorporated herein by reference.
- (27) 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, 2003 and are incorporated herein by reference.
- (28) Such document was previously filed as an Exhibit to the Company's Current Report on Form 8-K on October 28, 2003 and is incorporated herein by reference.
- (29) Such document was previously filed as an Exhibit to the Company's Current Report on Form 8-K on December 12, 2003 and is incorporated herein by reference.
- (30) 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, 2003 and are incorporated herein by reference.

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(b) Reports on Form 8-K:

A Form 8-K was filed dated October 14, 2003, reporting on Item 5, Other Events and Regulation FD Disclosure reporting, among other things, that the Company would delay the filing of its Annual Report on Form 10-K for its fiscal year ended June 30, 2003. No financial statements were filed with this report.

A Form 8-K was filed dated October 28, 2003 reporting on Item 5, Other Events and Regulation FD Disclosure and Item 7, Financial Statements and Exhibits, as to the Company's restructuring of debt and definitive agreement to sell the Company's wholly-owned subsidiary, Mercury Air Centers, Inc., to Allied Capital Corporation. No financial statements were filed with this report.

A Form 8-K was filed dated November 11, 2003 reporting on Item 5, Other Events and Regulation FD Disclosure reporting that the Company had informed the American Stock Exchange (the Exchange) that the Company required additional time to file its Annual Report on Form 10-K for the fiscal year ended June 30, 2003 with the Securities and Exchange Commission and that the Company also did not expect to meet the SEC filing deadline of its Quarterly Report on Form 10-Q for the period ended September 30, 2003 due on November 14, 2003. No financial statements were filed with this report.

A Form 8-K was filed dated November 25, 2003 reporting on Item 9, Regulation FD Disclosure, that the American Stock Exchange (the Exchange), among other things, (1) accepted the Company's plan to regain compliance with the Exchange's continuing listing standards and (2) that management had recommended to the Company's Audit Committee of the Board of Directors that it engage its current independent accountants to conduct and complete a re-audit of its financial statements for the previous two fiscal years ended June 30, 2002 and 2001. No financial statements were filed with this report.

A Form 8-K was filed dated December 2, 2003 reporting on Item 12, Disclosure of Results of Operations and Financial Condition, that the Company's management recommended to its audit committee that it engage its current independent public accountants to re-audit its financial statements for the previous two fiscal years ended June 30, 2002 and 2001, and that the Company's 2003 Annual Report on 10-K is expected to include a restated balance sheet and restated statements of operations and cash flows for the fiscal year ended June 30, 2002. No financial statements were filed with this report.

A Form 8-K was filed dated December 3, 2003 reporting on Item 12, Disclosure of Results of Operations and Financial Condition, as to its preliminary results of operations and financial condition for the three-month period ended September 30, 2003. Unaudited financial statements for such period were filed with this report.

A Form 8-K was filed dated December 15, 2003 reporting on Item 5, Other Events and Regulation FD Disclosure, announcing that the Company had entered into a settlement agreement relating to litigation with J O Hambro Capital Management Group Limited and certain of its affiliates and private clients (collectively J O Hambro). No financial statements were filed with this report.

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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

MERCURY AIR GROUP, INC.  
Registrant

/s/ Joseph Czyzyk

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Joseph Czyzyk  
*Chief Executive Officer*

/s/ Robert Schlax

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Robert Schlax  
*Chief Financial Officer*  
(Principal Financial Officer)

Date: February 17, 2004