# “It’s how you’d run an airline.”

Continental

Airlines

1998

Annual

Report

# 1998 Accomplishments

### Fly to Win

Operating margin was 10.4 percent with 10.6 percent available seat mile growth and 12.5 percent revenue passenger mile growth (equals $130 million more in pre-tax income than 1997, $214 million more than 1996 and $568 million more than 1995)

Maintained revenue per available seat mile premium to the industry while growing

Successfully integrated the regional jet into systemwide operations

Completed global network with Northwest, Alaska/Horizon, COPA, Aserca, AVANT and Air China

Rolled out new global advertising campaign (Work Hard. Fly Right.), growing our share of NYC business

Implemented international electronic ticketing and a new branded bank card

### Fund the Future

Completed $2.9 billion of financing at an average rate of 6.6 percent

Achieved a $140 million run rate on our $100 million non-value-added cost reduction target

Ended second consecutive year with more than $1 billion in cash ($1.4 billion in 1998)

Completed $223 million of $300 million share repurchase program

Announced order for Boeing 767-200 and 737-900 aircraft

Kept Houston and Cleveland airport construction projects on time and on budget

### Make Reliability a Reality

Delivered a consistent, reliable product every day, as measured by on-time arrivals, baggage delivery, fewest customer complaints and involuntary denied boardings

Opened Presidents Clubs in Dallas/Fort Worth, Atlanta, Washington D.C., Mexico City, Cleveland, Houston Terminal B and Houston South Concourse

Successfully integrated new Boeing 737-700, 737-800 and 777 aircraft into systemwide operations

### Working Together

Paid fourth consecutive year of profit sharing

Implemented vacation, sick leave pay, and holiday pay for part-time employees

Achieved smooth transition to new downtown headquarters

Signed five-year pilot contract

Signed three-year mechanic contract

Signed three-year extension to dispatcher contract

Improved health insurance and returned $8 million in premium costs to employees

### 1998 Awards and Recognition

Named to FORTUNE'S "100 Best Companies to Work For in America"

FORTUNE magazine - Most Improved Company of the Decade and 3rd place (up from last place two years ago) in "Most Admired" airline list

Aviation Week and Space Technology - "Best Managed" among U.S. carriers

The Wall Street Journal - Transatlantic business class rated highest among U.S. carriers

InsideFlyer's Freddie Awards - OnePass won 5 awards including "Program of the Year" and "Best Elite Level Program" for the second straight year

National Airline Quality Rating Study - Most Improved Airline and ranked 3rd (up from 5th last year and last 2 years ago)

Conde Nast Traveler - Best Transpacific and Best Transatlantic Business Class among U.S. carriers

Entrepreneur magazine - Top Transatlantic Business Class

Business Traveler International magazine - rated BusinessFirst wines best among U.S. carriers and 3rd worldwide

Hispanic magazine - one of "100 Companies Providing the Most Opportunities for Hispanics"

Travel Trade Gazette Europa - Top Airline to North America

# Financial Highlights and Operating Statistics

(In millions of dollars, except per share data)

| | Year Ended December 31, 1998 | 1997 | 1996 | 1995 | 1994 |
|---|---|---|---|---|---|
| Operating Revenue | $ 7,951 | $ 7,213 | $ 6,360 | $ 5,825 | $ 5,670 |
| Total Operating Expenses | 7,250 | 6,497 | 5,835 | 5,440 | 5,681 |
| Operating Income (Loss) | 701 | 716 | 525 | 385 | (11) |
| Income (Loss) Before Income Taxes, Minority Interest, Extraordinary Charge and Special Items[1] | 770 | 640 | 556 | 202 | (204) |
| Income (Loss) Before Extraordinary Charge (Loss) | 387 | 389 | 325 | 224 | (613) |
| Net Income (Loss) | 383 | 385 | 319 | 224 | (613) |
| Income (Loss) Applicable to Common Shares | $ 383 | $ 383 | $ 314 | $ 215 | $ (619) |
| Earnings (Loss) per Common Share | $ 6.34 | $ 6.65 | $ 5.75 | $ 4.07 | $ (11.88) |
| Earnings (Loss) per Common Share Assuming Full Dilution | $ 5.02 | $ 4.99 | $ 4.17 | $ 3.37 | $ (11.88) |

1 Special items include a fleet disposition/impairment loss of $122 million in 1998, a fleet disposition loss of $128 million in 1996, a gain on the sale of System One of $108 million in 1995 and a nonrecurring charge of $447 million in 1994.

# Operating Statistics

(Jet operations only, excluding regional jets operated by Continental Express)

| | 1998 | 1997 | 1996 | 1995 | 1994 |
|---|---|---|---|---|---|
| Revenue passengers (thousands) | 43,625 | 41,210 | 38,332 | 37,575 | 42,202 |
| Revenue passenger miles (millions) (a) | 53,910 | 47,906 | 41,914 | 40,023 | 41,588 |
| Available seat miles (millions) (b) | 74,727 | 67,576 | 61,515 | 61,006 | 65,861 |
| Passenger load factor (c) | 72.1% | 70.9% | 68.1% | 65.6% | 63.1% |
| Breakeven passenger load factor (d)(e) | 61.4% | 60.0% | 60.7% | 60.8% | 62.9% |
| Passenger revenue per available seat mile | 9.10¢ | 9.19¢ | 8.93¢ | 8.20¢ | 7.22¢ |
| Operating cost per available seat mile (e) | 8.93¢ | 9.07¢ | 8.77¢ | 8.36¢ | 7.86¢ |
| Average yield per revenue passenger mile (f) | 12.62¢ | 12.96¢ | 13.10¢ | 12.51¢ | 11.44¢ |
| Average price per gallon of fuel | 46.83¢ | 62.91¢ | 60.92¢ | 55.02¢ | 53.52¢ |
| Fuel gallons consumed (millions) | 1,487 | 1,357 | 1,228 | 1,203 | 1,349 |
| Actual aircraft in fleet at end of period (g) | 363 | 337 | 317 | 309 | 330 |

(a) The number of scheduled miles flown by revenue passengers.
(b) The number of seats available for passengers multiplied by the number of scheduled miles those seats are flown.
(c) Revenue passenger miles divided by available seat miles.
(d) The percentage of seats that must be occupied by revenue passengers in order for the airline to breakeven on income before income taxes, excluding nonrecurring charges, nonoperating items and other special items.
(e) 1998 excludes a fleet disposition/impairment loss totaling $122 million and 1996 excludes a fleet disposition loss totaling $128 million.
(f) The average revenue received for each mile a revenue passenger is carried.
(g) 1998 excludes six all-cargo 727 CMI aircraft and one A300 and one 747 Continental aircraft that were removed from service in 1995 and 1998, respectively. 1997 excludes six all-cargo 727 CMI aircraft and two 737-100's that were removed from service in 1997 and three DC-10-30 Continental aircraft that were delivered in 1997, but were not placed into service until 1998. 1996 excludes four all-cargo 727 aircraft at CMI, three A300 and one 747 Continental aircraft that were removed from service in 1995 and four DC-10-30 Continental aircraft that were delivered in 1996, but were not placed into service until 1997.

Continental Airlines earns a spot on FORTUNE Magazine's

# 100 BEST COMPANIES TO WORK FOR IN AMERICA

Continental Airlines recently earned a spot on FORTUNE Magazine's second annual list of "100 Best Companies to Work For in America." The company made its appearance in the top half of the list that polled more than 27,000 employees at hundreds of companies nationwide. CO ranked number 40, ahead of many other companies known for their employee-friendly atmosphere. FORTUNE's article read, "Who says you can't turn around a company reviled by both employees and customers? Since taking the captain's seat here in 1994, Gordon Bethune has made employee satisfaction a top priority."

The list is based on a range of criteria related to the work environment and company culture, compensation and benefits. When Gordon and Greg formed the Go Forward Plan, one of its primary goals was creating an environment where people enjoy coming to work. The company has many programs rewarding outstanding performance such as on-time bonuses and perfect attendance awards. They also realized that keeping employees informed of the company's performance was key. Corporate Communications offers the latest news in the Daily News Update, monthly CO Times and Go Forward Board. In addition, employees feel free to provide input at Open House meetings that Gordon and Greg hold on a monthly basis. Clearly CO's 48,000 co-workers take pride in their company, its accomplishments and want the public to know about it.


Work Hard.
Fly Right.
PAGE 4 OF 5
Continental
Depa

# To our co-workers, customers and stockholders,

By any measure, 1998 was our most successful year ever. This is the fourth straight year we've been able to make such a bold, positive statement.

The highlight of the year was *Fortune* magazine's recognition of Continental as one of the 100 Best Companies to Work For in America. Last year, *Fortune* named Continental the most improved company of the decade. This culminates a long history where Continental traditionally was ranked lowest in employee satisfaction of Fortune 500 companies before 1995. Ranking among the 100 Best Companies to Work For clearly is the greatest accolade Continental ever has received. We are proud *Fortune* and our co-workers have recognized Continental in this manner.

We continued to fill our trophy case in 1998 with a variety of other awards for our airline. Continental's BusinessFirst was recognized as best in class across the Atlantic by *The Wall Street Journal, Conde Nast Traveler, Entrepreneur* and *Smart Money* magazine, beating previous winners such as British Airways, American and Virgin. Continental's industry-leading OnePass program swept *InsideFlyer* magazine's prestigious 1999 Freddie Awards for the second straight year. The Freddie Awards are voted on by our nation's most frequent flyers, and OnePass captured five of the nine awards, including once again winning Program of the Year and Best Elite-Level Program.

These honors and awards are independent validation of something that we have known for several years — that Continental Airlines has achieved the essential elements of long-term success. We have a consistent, high-quality product that we are proud to deliver and people who like coming to work every day.

The *Fortune* 100 Best Companies to Work For award is the final validation that our turnaround is complete. Wall Street previously has recognized us as one of its financially best-performing companies. Our customers have recognized us through their votes in the J.D. Power awards and through our consistent high ranking in the U.S. Department of Transportation customer satisfaction measures. Our peers selected us as *Air Transport World* magazine's Airline of the Year. And now *Fortune* magazine and our employees have recognized us as one of the Best Companies to Work For in America. We now can unequivocally say that Continental is one of the best companies in the world—no matter how you choose to measure us.

As ever, our business is changing. 1998 marked the year global alliances began to form and these alliances are changing the competitive landscape of our industry. By aligning with Northwest Airlines in early

**"Working for Continental today is fun. We truly work as a team, and we're proud that our hard work is paying off in a big way."**

Lorenzo Romero
Engine Shop Technician



Continental's route map grew in 1998 as the carrier inaugurated service to new worldwide destinations. Most notably, Continental launched non-stop New York/Newark – Tokyo service, followed by Houston – Tokyo service in early 1999. Among other new routes, the airline also began service to Santiago from its Newark hub, further increasing its Latin American presence.

[ Above: Flight Attendants Hiromi Kurihara (l) and Chiharu Kimura (r); Right: Marlene Haddad, International Concierge ]


In 1998, Continental continued to increase its high-yield business customer mix. The New York metropolitan area, the largest air travel market in the world, remained a core focus for the airline. In fact, Continental is the only carrier with a hub in the New York area. The carrier also expanded products preferred by business travelers, such as electronic ticketing.

1998 and bringing together the other alliance partners of both carriers, Continental is assured of a major role in the global airline industry for many years to come.

Our challenge in 1999 will be to continue delivering an outstanding product while working with our new partners to implement a consistent, reliable global alliance. For us to be successful and win in the marketplace, our customers must experience a consistent, seamless product across the whole alliance. And the product must be as good or better than Continental's award-winning service today. Our customers deserve this, and we simply won't settle for anything less.

We have a lot of momentum and the world's greatest employees as we enter 1999.

## Go Forward Plan

Four years ago we started with the basic understanding that "What gets measured and rewarded gets done." This led to the development of a strategy implemented in January 1995 that we call the Go Forward Plan. While the Go Forward Plan has continued to evolve, it has served as the foundation of our business from early 1995 and will continue for the future. Its four cornerstones — Fly to Win, Fund the Future, Make Reliability a Reality, and Working Together — are practical, measurable and flexible and, most importantly, make sense to our co-workers.

Let's review what the Continental team accomplished over the last four years and what is in store for 1999.

## Fly to Win

Financially, 1998 was a home run for us. We achieved a record $770 million in pre-tax profit compared to pre-tax profit of $640 million in 1997, $556 million in 1996, and $202 million in 1995, with a $204 million pre-tax loss in 1994 (all special charges and gains excluded).

In 1995, we told you we were going to stop doing things that lose money — and we did. In 1996, we told you we were going to achieve a 10 percent operating margin before we started expanding — and we did. In 1997, we told you we were going to deliver 10 percent growth while maintaining a 10 percent operating margin (a first-time feat for the airline industry) — and we did.

In 1998, we told you we were going to repeat our 1997 growth and profit results. How did we do? We grew our seat miles 10.6 percent, faster than any major hub carrier; had a record load factor of 72.1 percent, one of the highest in the industry; and finished the year with a better than 10 percent operating margin. Our profit margin was near the top of the industry.

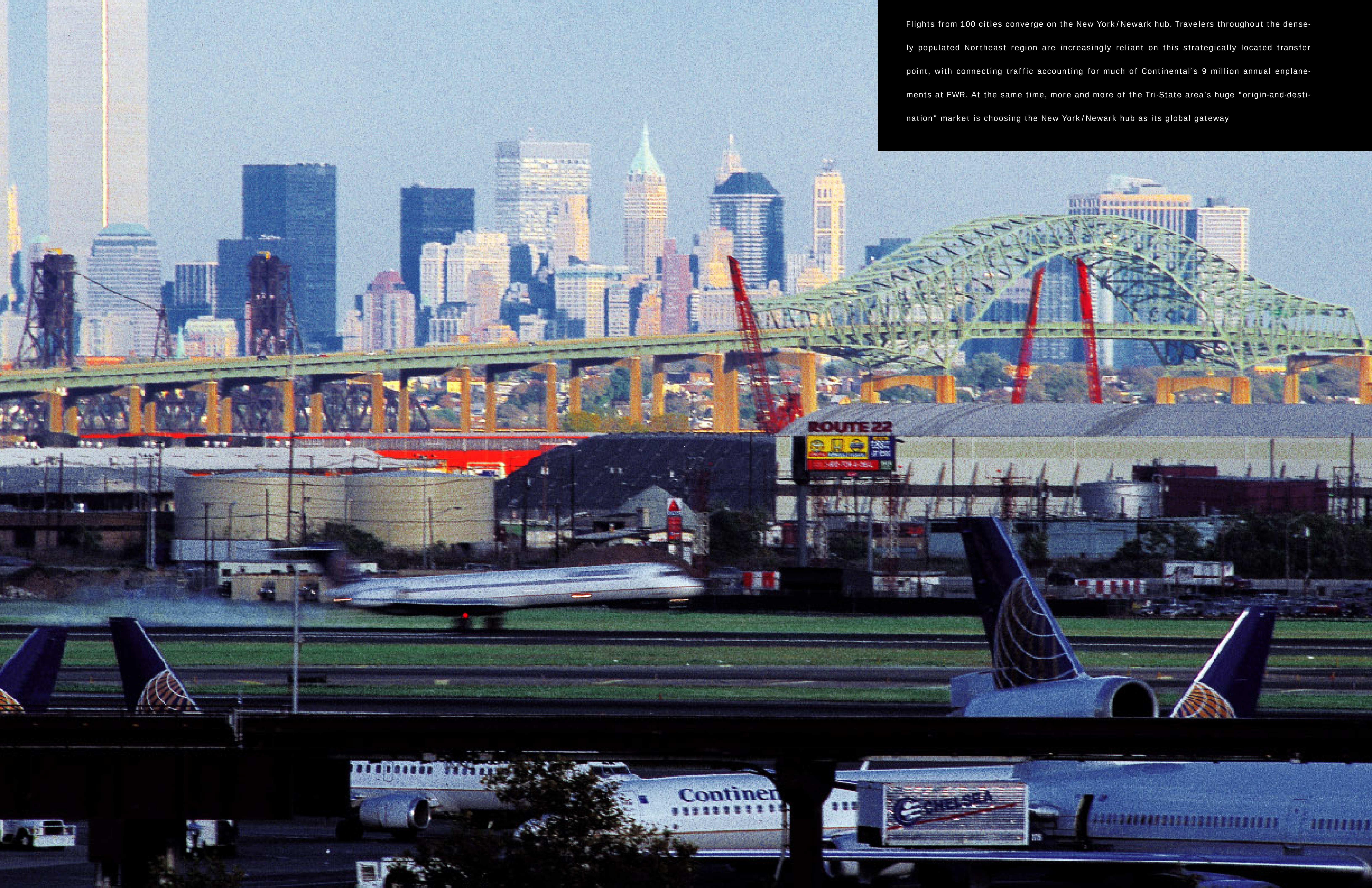
How did we accomplish these results?

We continued to leverage our under-developed franchise hubs in Houston, New York/Newark, Cleveland and Guam

**"I like the work environment at Continental, particularly the flexible scheduling. This is a fun crew to work with."**

Andrea Richards
Customer Service Agent

Flights from 100 cities converge on the New York/Newark hub. Travelers throughout the densely populated Northeast region are increasingly reliant on this strategically located transfer point, with connecting traffic accounting for much of Continental's 9 million annual enplanements at EWR. At the same time, more and more of the Tri-State area's huge "origin-and-destination" market is choosing the New York/Newark hub as its global gateway



Fleet modernization makes Continental the airline of choice. The carrier took delivery of 65 new aircraft in 1998, including the new Boeing 777, which it deployed on transpacific and select transatlantic flights. The airline also added the new generation Boeing 737-700 and -800 aircraft to its fleet last year. In 1999, Continental will take delivery of 57 new aircraft and will have an average fleet age of 7.6 by year-end 1999 — among the youngest jet fleets in the U.S.

[ Left: Captain Larry Camden ]

“We’ve learned to value our customers. Our top priorities are safety and delivering a great product, and I think we’re doing a great job.”

Frederick Miles
Chelsea Safety Lead

with a profitable core schedule. Serving as the hub carrier in these four markets has increased both the size and predictability of our profits. Despite our profitable growth over the past two years, our main hubs still are underdeveloped compared to our competitors. So over the next several years Continental should continue to outpace our industry in growth.

We made significant progress in 1998 in developing our route and alliance network.

Our domestic route system grew with many new frequencies and destinations. Transcon departures have increased 22 percent year over year, and we’re serving more transcontinental destinations from the New York area than any other airline. We also began to implement our alliance with Northwest Airlines, starting with reciprocal frequent flyer programs, club memberships and code sharing on many complementary routes. In 1999, we expect to use the combined distribution power of Continental and our partners Northwest, America West, and Alaska/Horizon to compete effectively with the big three U.S. airlines.

Our transatlantic route system has grown from only four destinations in 1994 to 17 by mid-1999 with the addition of Amsterdam, Brussels, Zurich and Tel Aviv. With the addition of these destinations we’ll offer more transatlantic flights from the New York area than any other carrier in the history of U.S. aviation. Our existing alliances with Air France, Alitalia, CSA Czech, and Virgin Atlantic Airways permit us to expand the scope of our business to many new markets. We are confident we have alliance partners that will ensure our long-term growth and profitability.

In Latin America, we have become the second largest carrier in the market no matter how you measure us. We rapidly have grown our hubs in the second and third largest markets to Latin America (New York/Newark and Houston) leaving others to fight it out in Miami. In fact, our Houston hub offers more non-stop destinations to Latin America than any other carrier’s hub in the United States. Our growth to Latin America essentially is complete. Our alliance network in Latin America also has grown substantially with the addition of VASP of Brazil, Aserca/Air Aruba of Venezuela, ACES of Colombia, and AVANT of Chile. In addition, we purchased 49 percent of COPA in Panama and with them we look forward to building the best hub in Central America.

In Asia, we added service from New York/Newark and Houston to Tokyo with early results much better than we ever expected. Our alliances with Northwest, EVA and Air China augment our new service to give us a significant presence in the transpacific market.

Our award-winning service and expanding network continue to attract record numbers of business customers. As our percent of business customers has increased, so has our revenue premium versus our competitors.

We also launched a new ad campaign in 1998: "Work Hard. Fly Right." The new slogan represents who we are and what we are all about. There are no fluffy promises, just a commitment that the 48,000 professional men and women at Continental will work hard every day to get you safely to your destination on-time, with your bags, to serve you good food at meal times and, with our new airplanes, to show you movies when you are bored on many long-haul flights. We've also focused the new campaign to make Continental's presence as New York/New Jersey's only hub carrier better known in the lucrative New York marketplace.

Our challenge for 1999 will be to help mold our outstanding group of alliance partners into a cohesive, consistent, award-winning network with an outstanding product. We clearly want to be your first choice for air travel wherever you fly.

## Fund the Future

In addition to record profitability, we ended the year with a record $1.4 billion in cash. This is up from last year's cash balance of $1 billion and represents a dramatic turnaround from early 1995. We clearly have the financial strength to weather any storm.

We used our credibility in the financial markets to build and finance new facilities in our hubs to support our growth and embark on the most aggressive fleet renewal campaign in recent airline history.

Our new facilities include new terminals in Houston and Cleveland that will be fully operational in May 1999. In 1998, we completed new support facilities – such as maintenance hangars, parts warehouses, cargo buildings, training centers and simulators, and crew lounges and breakrooms – to provide our co-workers with the right tools to do their jobs. In 1999, we plan to break ground on an attractive new terminal, parking structure and roadway system in our New York/Newark hub.

We are taking a new airplane about every five days to replace older aircraft. The net effect is that our customers will have a much better product at an overall lower cost to Continental. The orders, coupled with aircraft lease expirations and extensions, permit Continental to grow from zero to 8 percent annually based on market demand. By the end of this year, Continental's jet fleet age will be only 7.6 years, one of the youngest in our industry.

These new airplanes include the Boeing 737-500 (104 seats); the newer, faster B737-700 (124 seats); B737-800 (155 seats); and B757 (183 seats) aircraft to replace our DC-9, B737-100 and -200 and B727 aircraft before the government-mandated noise reductions take effect at year end. In 1998, we took delivery of our

**"I enjoy flying for Continental, particularly our new generation Boeing 737 aircraft. I hope to see our airline continue to grow and prosper."**

Captain Randy McKnelly
737 Captain

Continental has earned numerous awards by consistently improving its product to suit its customers. Larger overhead storage bins are being installed in 181 aircraft; new 737s and 777s already include the larger bins. BusinessFirst remains the preferred forward cabin on international flights. And customers traveling on Continental's newer aircraft enjoy state-of-the-art entertainment systems, enabling them to work or play while in flight.

[ Above: Jacquelyn Gilroy, Flight Attendant; Right: Mia Schneider, Flight Attendant ]

The 50-seat ExpressJet is winning rave reviews. Communities historically served by turboprops are clamoring to move up to the speed and comfort offered by this newest generation of regional aircraft. A 37-seat version enters service in North America for the first time with Continental Express in July 1999. With 99 ExpressJets either in the fleet or on order, and options for 175 more, Continental Express has the ability to eliminate turboprops entirely within five years.


Operationally, Continental continued to excel in 1998. The carrier recognizes that customers' primary interest is arriving safely, on time and with their bags, and Continental remains near the top of the industry in these Department of Transportation measures. Continental's various departments work together closely to ensure that customers' expectations are met on a daily basis.

[ Above: C.D. McLean Executive V. P. – Operations (r) and Glen Hauenstein, V. P. – Scheduling (l); Left: Randy Grace, Sr. Technical Planner and Mark Johnson, Sr. Material Coordinator ]

“As a flight attendant, I’ve witnessed Continental’s turnaround firsthand. It’s been a great ride, and I’m looking forward to a long future with the company.”

Deanna Davis
Flight Attendant

first six “Queen of the Skies,” the all new Boeing 777 airplane. The new widebody B777 (283 seats), B767-400 (235 seats) and B767-200 (174 seats) will replace our existing DC-10 fleet by 2003. At Continental Express, we continued our program to move to an all jet fleet by 2003 by aggressively adding the fast, quiet Embraer 145 (50 seats) and the new EMB-135 (37 seats) regional jets.

We’re currently financing new airport facilities for 20-30 years at a fixed rate of under 6 percent and new airplanes for up to 20 years at a fixed rate of under 7 percent. These low interest rates, coupled with the guaranteed lowest price for airplanes, mean the company will be competitive for many years to come. We have found that accessing reasonable cost financing is much easier when you have good profits and a great product with a competitive cost structure.

During 1998, we were successful in removing over $100 million of non-value-added costs from our business. These are costs that do not impact our product quality, such as reducing aircraft insurance costs. We have set a goal to remove an additional $50 million in non-value-added costs during 1999.

## Make Reliability a Reality

Continental is consistently clean, safe and reliable. We get you to your destination safely, on-time and with your bags. We knew when we put together our first Go Forward Plan in 1995 that we needed to focus on the basics of our business.

Throughout 1998, we have worked to provide product enhancements and to select services that customers want and will pay for – such as larger overhead bins and more closets so more carry-on bags can be safely and comfortably stowed in the cabin, and more comfortable seats with adjustable headrests, computer power terminals and state-of-the-art entertainment systems on new aircraft to help make work and play time more productive and enjoyable. We’ve opened new Presidents Club lounges with free beverages in key cities, and we’ve provided reliable GTE phones on all airplanes scheduled to remain in our fleet after the year’s end.

We continue to win awards for thinking about our customers and our co-workers first, not as an afterthought. It is our quality product and service that keeps us ahead of the competition. All of our departments work together, with our 1-800 employee hotline, to ensure operational problems are fixed right away. Work Hard. Fly Right. is not merely a slogan – it’s who we are and what we do every day.

## Working Together

Working Together works! Our focus is on treating each other with dignity and respect, setting direction and then letting everyone do their job without interference from management, based on what benefits the customer and the company. We reward all of our co-workers with on-time bonuses and profit sharing so when the customers and investors win, we all win. We award all-tax-paid Ford Explorers for perfect attendance (47 of them to date), which has helped turn us into a real championship team.

Everyone seems to want to work at Continental lately, and no one really wants to leave. During 1998, we received more than 90,000 resumes for only 8,664 jobs, and our turnover reached an all-time low of 7.2 percent. No wonder Continental was chosen as one of the 100 Best Companies to Work For in America!

We remain focused on regularly communicating with our 48,000 employees, and we hold frequent forums where employees and management can visit and hear what each other has to say.

All of our co-workers have received healthy pay increases over the last few years, and agreements are in place with most of our union and non-union work groups to ensure we will deliver on the promise we made a few years ago – industry standard pay for everyone by 2000. We're doing this because it is the right thing to do. Everyone needs to be treated fairly, and we refuse to finance the company on the backs of our co-workers. We sometimes may debate what is fair, but we respect each other and have proven time and time again we can resolve our differences quickly and amicably.

We also have focused on important benefit issues such as using our buying power to implement "Best in Market" health care plans that reduce the costs for quality medical care for our co-workers at a time when the cost of health care at other companies is increasing dramatically. We also have extended health care and other benefits to part-time workers and added an additional holiday for everyone. We added an extra week of vacation for our most senior employees.

Working Together has given us careers, not just jobs, at the best airline in the world. We are winners and are proud to be part of the Continental family.

Each year, we know when we set our goals that we need our co-workers to do their part. No one at Continental will relax in 1999 as we continue to do a great job every day for our customers and our shareholders. We Work Hard and Fly Right.

Thanks again for choosing us.

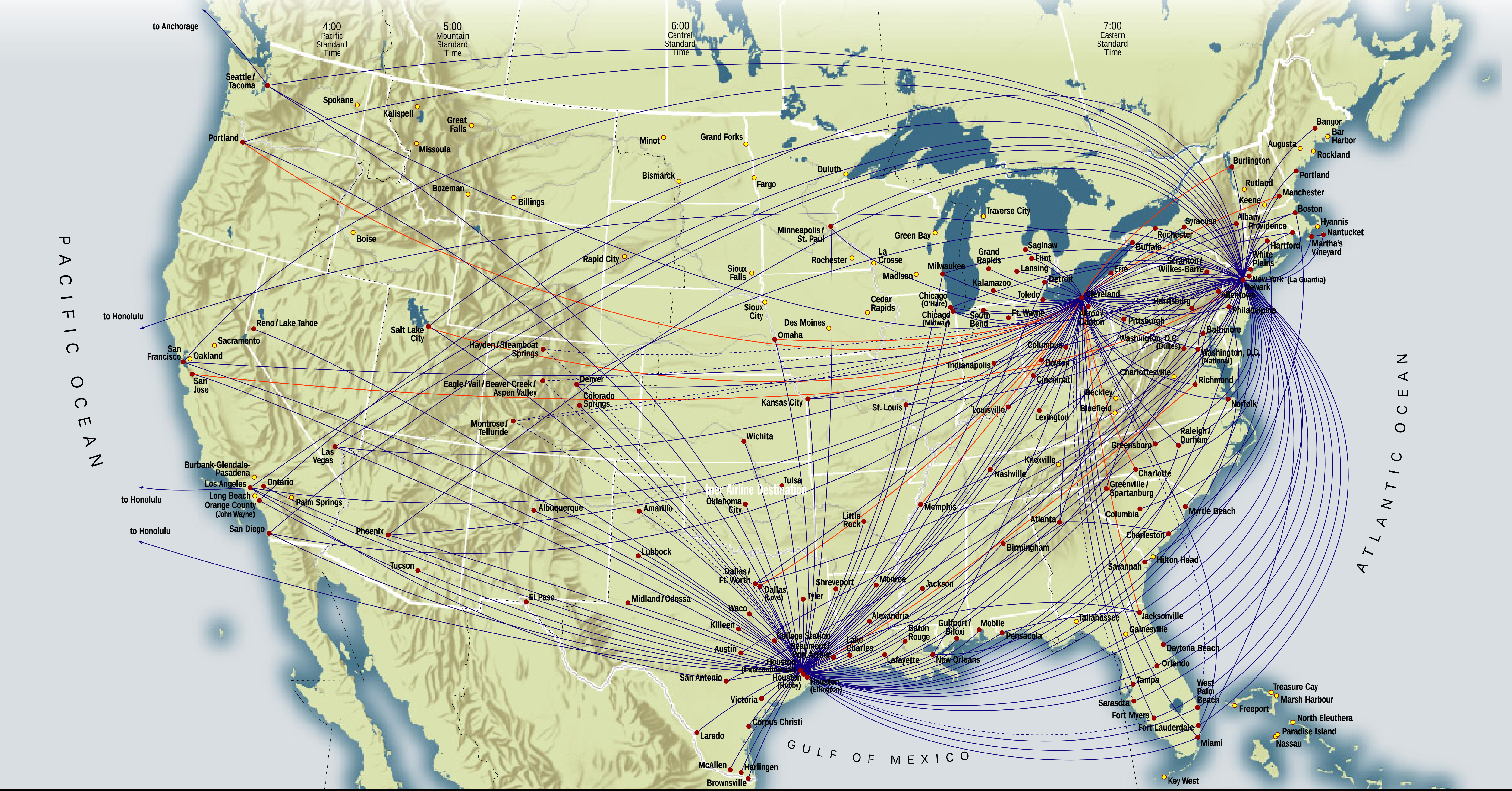
*Gordon Bethune*
**Chairman of the Board and Chief Executive Officer**

*Greg Brenneman*
**President and Chief Operating Officer**

**"There are a lot of reasons that Continental is a great place to work – on-time bonuses and profit sharing, for instance. But mostly, we take a lot of pride in being the best airline in the industry."**

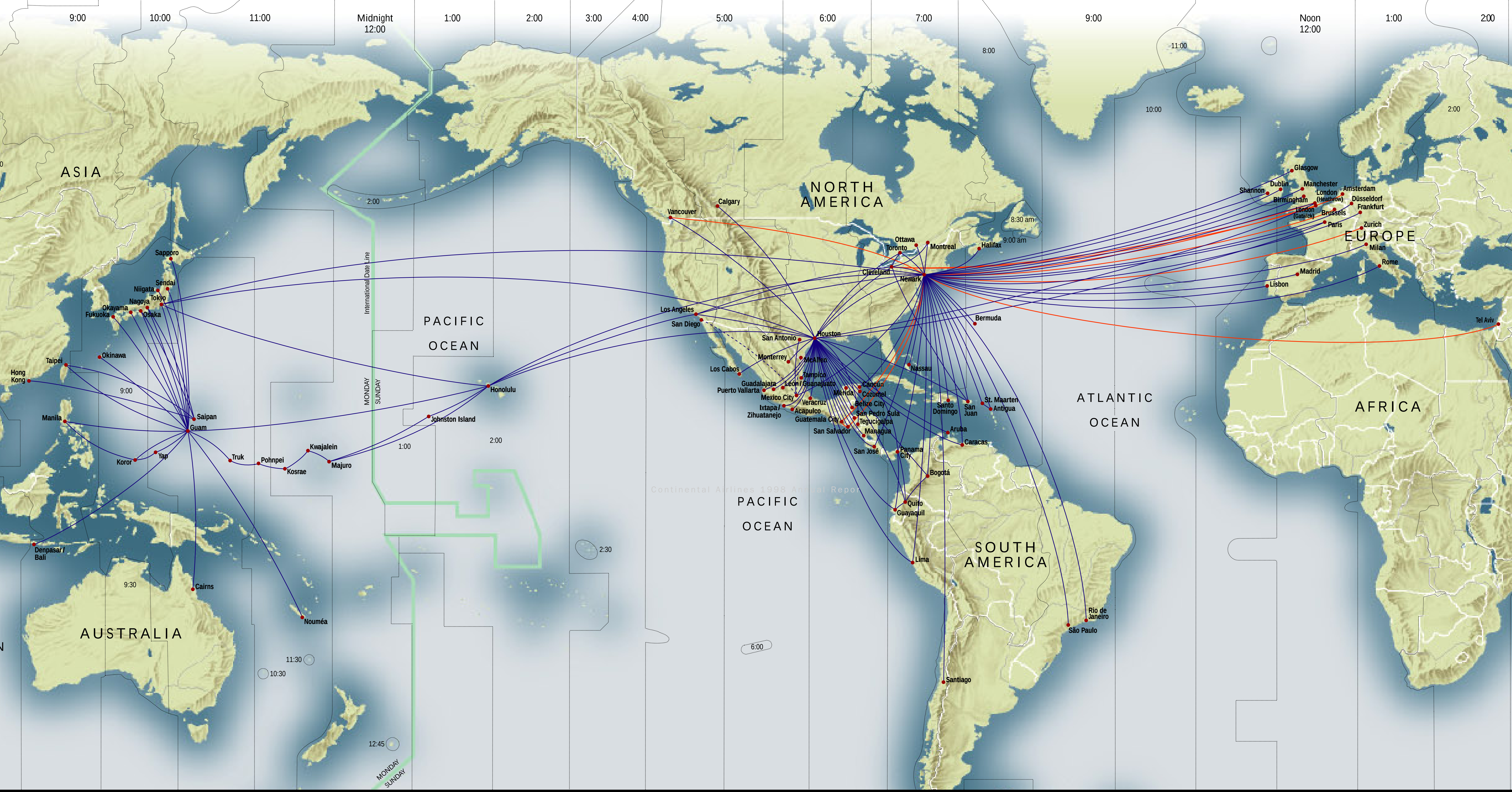
Ed Haoui
Customer Service Agent Lead


Gordon Bethune and Greg Brenneman developed Continental's highly successful Go Forward Plan, which was successfully implemented by the airline's 48,000 employees around the world. They continue to believe their co-workers are responsible for making Continental the "carrier of choice" for a growing number of travelers worldwide.




# United States Route System

- Continental Route
- Future Service
- Seasonal Service
- Continental Destination
- Par




# International Route System

Continental Route

Future Service

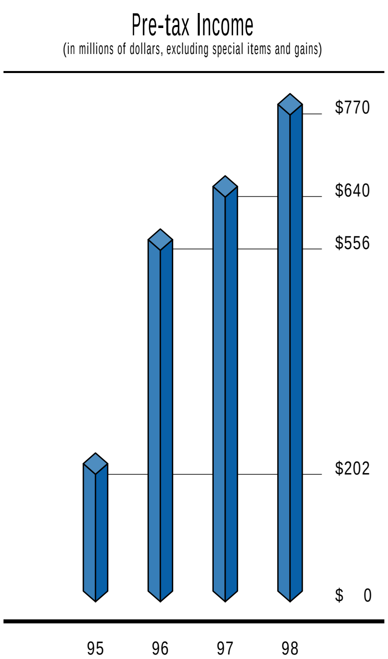
Seasonal Service

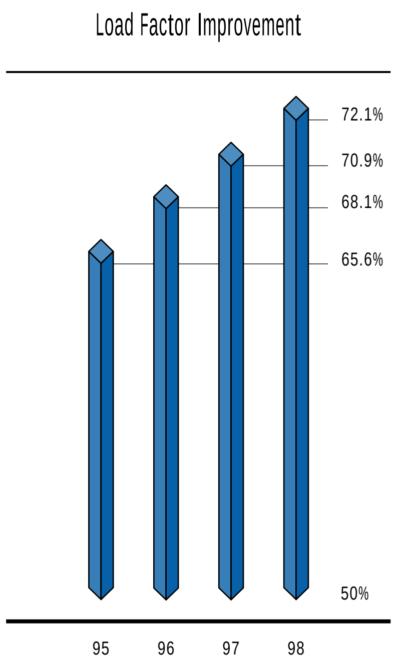
Continental Destination

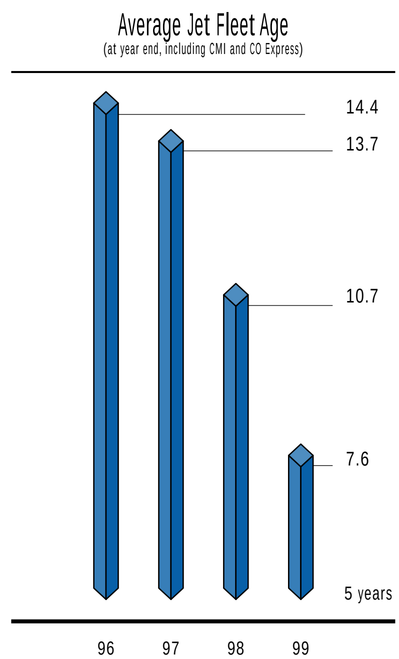


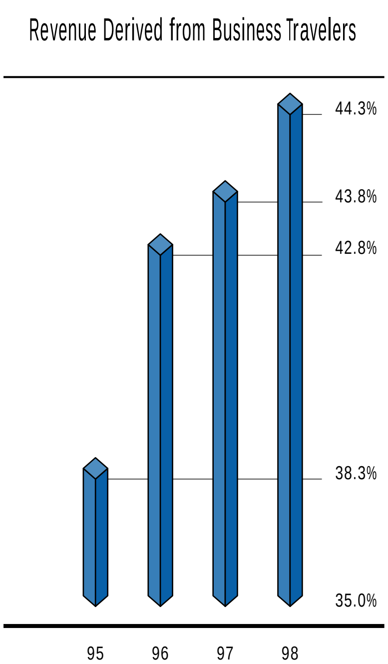
t

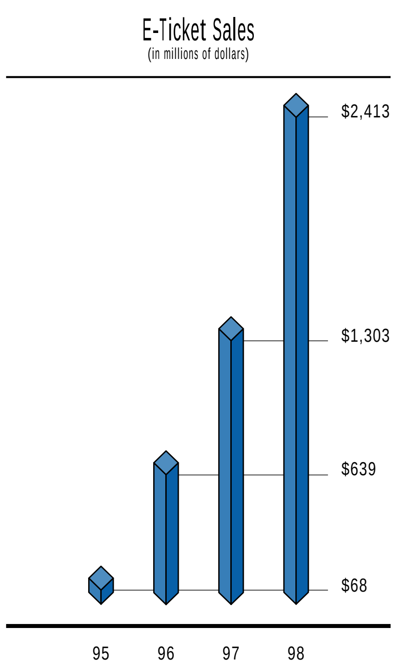
# Continental at a Glance

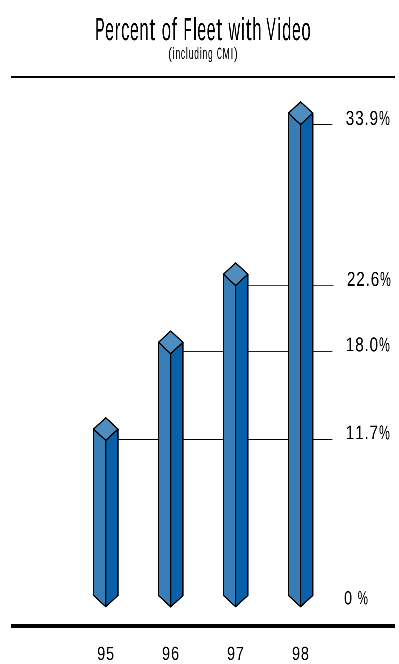


## Financial Information

# Management's Discussion and Analysis of Financial Condition and Results of Operations.

The following discussion may contain forward-looking statements. In connection therewith, please see the cautionary statements contained in Continental Airlines, Inc.'s Annual Report on Form 10-K for the year ended December 31, 1998, which identifies important factors that could cause actual results to differ materially from those in the forward-looking statements. Hereinafter, the terms "Continental" and the "Company" refer to Continental Airlines, Inc. and its subsidiaries, unless the context indicates otherwise.

Continental's results of operations are impacted by seasonality (the second and third quarters are generally stronger than the first and fourth quarters) as well as numerous other factors that are not necessarily seasonal, including the extent and nature of competition from other airlines, fare sale activities, excise and similar taxes, changing levels of operations, fuel prices, foreign currency exchange rates and general economic conditions. To date, the recent turmoil in the world's financial markets has not had a material adverse impact on the Company's results of operations, although the Company has experienced yield degradations in domestic and certain international markets. Although the results in Asia of Continental Micronesia, Inc. ("CMI"), a wholly owned subsidiary of the Company, have declined in recent years, the Company successfully redeployed CMI capacity into stronger domestic markets and CMI's recent results have improved. In addition, the Company believes it is well positioned to respond to market conditions in the event of a sustained economic downturn for the following reasons: underdeveloped hubs with strong local traffic; a flexible fleet plan; a strong cash balance, a $225 million unused revolving credit facility and a well developed alliance network.

## Results of Operations

The following discussion provides an analysis of the Company's results of operations and reasons for material changes therein for the three years ended December 31, 1998.

*Comparison of 1998 to 1997.* The Company recorded consolidated net income of $383 million and $385 million for the years ended December 31, 1998 and 1997 (including special charges), respectively. Net income in 1998 was significantly impacted by a $77 million ($122 million before taxes) fleet disposition/impairment loss resulting from the Company's decision to accelerate the retirement of certain jet and turboprop aircraft. Management believes that the Company benefited in the first quarter of 1997 from the expiration of the aviation trust fund tax (the "ticket tax"). The ticket tax was reinstated on March 7, 1997. Management believes that the ticket tax has a negative impact on the Company, although neither the amount of such negative impact directly resulting from the reimposition of the ticket tax, nor the benefit realized by its previous expiration, can be precisely determined.

Passenger revenue increased 10.6%, $706 million, during 1998 as compared to 1997. The increase was due to a 12.5% increase in revenue passenger miles, partially offset by a 2.6% decrease in yield. The decrease in yield was due to lower industry-wide fare levels and an 8% increase in average stage length.

Cargo and mail increased 6.6%, $17 million, due to an increase in freight revenue resulting from strong international volumes and strong growth in Continental's express delivery service.

Other operating revenue increased 5.1%, $15 million, due to an increase in revenue related to the Company's frequent flyer program ("OnePass").

Wages, salaries and related costs increased 22.3%, $404 million, during 1998 as compared to 1997, primarily due to an 11.2% increase in average full-time equivalent employees to support increased flying and higher wage rates resulting from the Company's decision to increase employee wages to industry standards by the year 2000.

Aircraft fuel expense decreased 17.9%, $158 million, in 1998 as compared to the prior year. The average price per gallon decreased 25.6% from 62.91 cents in 1997 to 46.83 cents in 1998. This reduction was partially offset by a 9.6% increase in the quantity of jet fuel used principally reflecting increased capacity.

Aircraft rentals increased 19.6%, $108 million, during 1998 as compared to 1997, due primarily to the delivery of new leased aircraft.

Maintenance, materials and repairs increased 8.4%, $45 million, during 1998 as compared to 1997. Aircraft maintenance expense in the second quarter of 1997 was reduced by $16 million due to the reversal of reserves that were no longer required as a result of the acquisition of 10 aircraft previously leased by the Company. In addition, maintenance expense increased due to the overall increase in flight operations offset by newer aircraft and the volume and timing of engine overhauls as part of the Company's ongoing maintenance program.

Depreciation and amortization expense increased 15.7%, $40 million, in 1998 compared to 1997 primarily due to the addition of new aircraft and related spare parts. These increases were partially offset by an approximate $18 million reduction in the amortization of reorganization value in excess of amounts allocable to identifiable assets and routes, gates and slots resulting from the recognition of previously unbenefited net operating losses ("NOLs").

On August 11, 1998, Continental announced that CMI plans to accelerate the retirement of its four Boeing 747 aircraft by April 1999 and its remaining thirteen Boeing 727 aircraft by December 2000. The Boeing 747s will be replaced by DC-10-30 aircraft and the Boeing 727 aircraft will be replaced with a reduced number of Boeing 737 aircraft. In addition, Continental Express, Inc. ("Express"), a wholly owned subsidiary of the Company, will accelerate the retirement of certain turboprop aircraft by December 2000, including its fleet of 32 Embraer 120 ("EMB-120") turboprop aircraft, as regional jets are acquired to replace turboprops. As a result of its decision to accelerate the retirement of these aircraft, Continental recorded a fleet disposition/impairment loss of $77 million ($122 million before taxes) in the third quarter of 1998.

Other operating expense increased 10.5%, $157 million, in 1998 as compared to the prior year, primarily as a result of increases in passenger and aircraft servicing expense, reservations and sales expense and other miscellaneous expense, primarily due to the 10.6% increase in available seat miles.

Interest expense increased 7.2%, $12 million, due to an increase in long-term debt resulting from the purchase of new aircraft.

Interest capitalized increased 57.1%, $20 million, due to increased capital spending and a higher average balance of purchase deposits for flight equipment.

The Company's other nonoperating income (expense) in 1998 included a $6 million gain on the sale of America West Holdings Corporation ("America West Holdings") stock.

*Comparison of 1997 to 1996.* The Company recorded consolidated net income of $385 million and $319 million for the years ended December 31, 1997 and 1996, respectively, including a $77 million fleet disposition loss ($128 million before taxes) in 1996 and after-tax extraordinary charges relating to the early extinguishment of debt of $4 million and $6 million in 1997 and 1996, respectively. Management believes that the Company benefited in the first three quarters of 1996 and in the first quarter of 1997 from the expiration of the ticket tax on December 31, 1995 and December 31, 1996, respectively. The ticket tax was reinstated on August 27, 1996 and again on March 7, 1997. Management believes that the ticket tax has a negative impact on the Company, although neither the amount of such negative impact directly resulting from the reimposition of the ticket tax, nor the benefit realized by its expiration, can be precisely determined. Additionally, the Company benefited in the first six months of 1996 from the recognition of previously unbenefited post-reorganization NOLs.

Passenger revenue increased 13.4%, $789 million, during 1997 compared to 1996. The increase was due to a 14.3% increase in revenue passenger miles on capacity growth of 9.9% offset by a 1.1% decrease in yield.

Cargo and mail revenue increased 11.2%, $26 million, during 1997 compared to 1996 due to an increase in cargo capacity and mail volumes, primarily in international markets.

Other operating revenue increased 14.8%, $38 million, from 1996 to 1997 primarily as a result of an increase in revenue related to frequent flyer mileage credits sold to participating partners in the OnePass program.

Wages, salaries and related costs increased 17.1%, $265 million, during 1997 as compared to 1996 due in part to a 9.6% increase in the average number of full-time equivalent employees from approximately 34,300 for the year ended December 31, 1996 to 37,600 for the year ended December 31, 1997. Wages and salaries also increased in 1997 due to a $29 million accrual for the impact of the tentative collective bargaining agreement with the pilots and an increase in employee incentives of $29 million.

Aircraft fuel expense increased 14.3%, $111 million, from 1996 to 1997 primarily due to a 10.5% increase in the quantity of jet fuel used from 1.228 billion gallons during 1996 to 1.357 billion gallons during 1997, resulting from increased flying. In addition, the average price per gallon, net of fuel hedging gains of $65 million in 1996, increased 3.3% from 60.9 cents in 1996 to 62.9 cents in 1997.

Aircraft rentals increased 8.3%, $42 million, from 1996 to 1997, primarily as a result of the delivery of new aircraft throughout 1997, net of retirements.

Commissions expense increased 11.2%, $57 million, in 1997 compared to 1996, primarily due to increased passenger revenue.

Maintenance, materials and repairs increased 16.5%, $76 million, during 1997 as compared to 1996, principally due to the volume and timing of engine overhauls, increase in component costs and routine maintenance as part of the Company's ongoing maintenance program. Aircraft maintenance expense was reduced by $16 million in 1997 due to the reversal of reserves that are no longer required as a result of the acquisition of 10 aircraft previously leased by the Company.

Other rentals and landing fees increased 12.9%, $45 million, during 1997 compared to 1996 due to higher facilities rentals and landing fees resulting from increased operations.

During the third quarter of 1996, the Company recorded a fleet disposition loss of $77 million ($128 million before taxes), related primarily to (i) the writedown of Stage 2 aircraft inventory to its estimated fair value; and (ii) a provision for costs associated with the return of leased aircraft at the end of their respective lease terms.

Other operating expense increased 14.9%, $194 million, in 1997 as compared to 1996, primarily as a result of increases in passenger services, advertising and publicity, reservations and sales expense and other miscellaneous expense.

Interest income increased 30.2%, $13 million, in 1997 compared to the prior year principally due to an increase in the average invested balance of cash and cash equivalents.

Interest capitalized increased $30 million in 1997 compared to 1996 as a result of higher average purchase deposits for flight equipment resulting from the pending acquisition of new aircraft.

Other nonoperating income (expense) for the year ended December 31, 1996 included an $18 million gain related to the sale of America West Holdings common stock and warrants.

The income tax provision for the year ended December 31, 1997 and 1996 of $237 million and $86 million, respectively, consists of federal, state and foreign income taxes. During the second quarter of 1996, the Company had fully utilized previously unbenefited post-reorganization NOLs, and began accruing income tax expense.

## Certain Statistical Information

An analysis of statistical information for Continental's jet operations, excluding regional jets operated by Express, for each of the three years in the period ended December 31, 1998 is as follows:

| | 1998 | Net Increase/ (Decrease) 1998-1997 | 1997 | Net Increase/ (Decrease) 1997-1996 | 1996 |
|---|---|---|---|---|---|
| Revenue passenger miles (millions) (1) | 53,910 | 12.5% | 47,906 | 14.3% | 41,914 |
| Available seat miles (millions) (2) | 74,727 | 10.6% | 67,576 | 9.9% | 61,515 |
| Passenger load factor (3) | 72.1% | 1.2 pts. | 70.9% | 2.8 pts. | 68.1% |
| Breakeven passenger load factor (4), (5) | 61.4% | 1.4 pts. | 60.0% | (0.7)pts. | 60.7% |
| Passenger revenue per available seat mile (cents) | 9.10 | (1.0)% | 9.19 | 2.9% | 8.93 |
| Total revenue per available seat miles (cents) | 9.98 | (1.1)% | 10.09 | 3.0% | 9.80 |
| Operating cost per available seat mile (cents) (5) | 8.93 | (1.5)% | 9.07 | 3.4% | 8.77 |
| Average yield per revenue passenger mile (cents) (6) | 12.62 | (2.6)% | 12.96 | (1.1)% | 13.10 |
| Average fare per revenue passenger | $155.95 | 3.5% | $150.63 | 5.1% | $143.27 |
| Revenue passengers (thousands) | 43,625 | 5.9% | 41,210 | 7.5% | 38,332 |
| Average length of aircraft flight (miles) | 1,044 | 8.0% | 967 | 7.9% | 896 |
| Average daily utilization of each aircraft (hours) (7) | 10:13 | 0.0% | 10:13 | 2.3% | 9:59 |
| Actual aircraft in fleet at end of period (8) | 363 | 7.7% | 337 | 6.3% | 317 |

Continental has entered into block space arrangements with certain other carriers whereby one or both of the carriers is obligated to purchase capacity on the other. The table above excludes 1.9 billion and 738 million available seat miles, together with related revenue passenger miles and enplanements, operated by Continental but purchased and marketed by the other carrier in 1998 and 1997, respectively, and includes 358 million available seat miles, together with related revenue passenger miles and enplanements, operated by other carriers but purchased and marketed by Continental in 1998.

(1) The number of scheduled miles flown by revenue passengers.

(2) The number of seats available for passengers multiplied by the number of scheduled miles those seats are flown.

(3) Revenue passenger miles divided by available seat miles.

(4) The percentage of seats that must be occupied by revenue passengers in order for the airline to break even on an income before income taxes basis, excluding nonrecurring charges, nonoperating items and other special items.

(5) 1998 excludes a fleet disposition/impairment loss totaling $122 million and 1996 excludes a fleet disposition loss totaling $128 million.

(6) The average revenue received for each mile a revenue passenger is carried.

(7) The average number of hours per day that an aircraft flown in revenue service is operated (from gate departure to gate arrival).

(8) Excludes all-cargo 727 aircraft (six in 1998 and 1997 and four in 1996) at CMI.

## Liquidity and Capital Resources

During 1998 and early 1999, the Company completed a number of transactions intended to strengthen its long-term financial position and enhance earnings:

- In February 1998, the Company completed an offering of $773 million of pass-through certificates used to finance (through either leveraged leases or secured debt financings) the debt portion of the acquisition cost of 24 aircraft delivered from February 1998 through December 1998.
- During the first quarter of 1998, Continental completed several offerings totaling approximately $98 million aggregate principal amount of tax-exempt special facilities revenue bonds to finance or refinance certain airport facility projects. These bonds are payable solely from rentals paid by Continental under long-term lease agreements with the respective governing bodies.
- In April 1998, the Company completed an offering of $187 million of pass-through certificates used to refinance the debt related to 14 aircraft currently owned by Continental.
- During the fourth quarter of 1998, the Company completed an offering of $524 million of pass-through certificates to be used to finance (through either leveraged leases or secured debt financings) the debt portion of the acquisition cost of up to 14 aircraft scheduled to be delivered from December 1998 through May 1999.
- In November 1998, the Company exercised its right and called for redemption approximately half of its outstanding 8-1/2% Convertible Trust Originated Preferred Securities ("TOPrS"). The TOPrS were convertible into shares of Class B common stock at a conversion price of $24.18 per share of Class B common stock. As a result of the call for redemption, 2,688,173 TOPrS were converted into 5,558,649 shares of Class B common stock. In December 1998, the Company called for redemption the remaining outstanding TOPrS. As a result of the second call, the remaining 2,298,327 TOPrS were converted into 4,752,522 shares of Class B common stock during January 1999.
- In December 1998, the Company sold $200 million principal amount of 8% unsecured senior notes due in December 2005. The proceeds will be used for general corporate purposes.
- In February 1999, the Company completed an offering of $806 million of pass-through certificates to be used to finance (through either leveraged leases or secured debt financings) the debt portion of the acquisition cost of up to 22 aircraft scheduled to be delivered from March 1999 through September 1999.

At the direction of an independent trustee, the cash proceeds from the pass-through certificate transactions are deposited with an escrow agent and enable the Company to finance (through either leveraged leases or secured debt financings) the debt portion of the acquisition cost of new aircraft. As of February 8, 1999, approximately $1.1 billion of the proceeds remain on deposit. If any funds remain as deposits at the end of the specified delivery periods, such funds will be distributed back to the certificate holders.

As of December 31, 1998, Continental had approximately $2.7 billion (including current maturities) of long-term debt and capital lease obligations, and had approximately $1.3 billion of Continental-obligated mandatorily redeemable preferred securities of subsidiary trust and common stockholders' equity, a ratio of 2.1 to 1, compared to 1.6 to 1 at December 31, 1997.

As of December 31, 1998, the Company had $1.4 billion in cash and cash equivalents (excluding restricted cash), compared to $1.0 billion as of December 31, 1997. Net cash provided by operating activities decreased $80 million during the year ended December 31, 1998 compared to the same period in the prior year primarily due to an increase in accounts receivable due to increased operations. Net cash used by investing activities for the year ended December 31, 1998 compared to the same period in the prior year increased $41 million, primarily as a result of higher capital and fleet-related expenditures in 1998 offset by higher purchase deposits refunded in connection with aircraft delivered in 1998. Net cash provided by financing activities increased $474 million primarily due to a decrease in payments on long-term debt and capital lease obligations and an increase in proceeds received from the issuance of long-term debt.

Continental has lines of credit totaling $225 million, and significant encumbered assets.

*Deferred Tax Assets.* During the first quarter of 1998, the Company consummated several transactions, the benefit of which resulted in the elimination of reorganization value in excess of amounts allocable to identifiable assets of $164 million. During the third and fourth quarters of 1998, the Company determined that additional NOLs of the Company's predecessor could be benefited and accordingly reduced both the valuation allowance and routes, gates and slots by $190 million. To the extent the Company were to determine in the future that additional NOLs of the Company's predecessor could be recognized in the accompanying consolidated financial statements, such benefit would further reduce routes, gates and slots. As of December 31, 1998, the Company had deferred tax assets aggregating $803 million, including $372 million of NOLs, and a valuation allowance of $263 million.

As a result of NOLs, the Company will not pay United States federal income taxes (other than alternative minimum tax) until it has recorded approximately an additional $1.1 billion of taxable income following December 31, 1998. Section 382 of the Internal Revenue Code ("Section 382") imposes limitations on a corporation's ability to utilize NOLs if it experiences an "ownership change". In general terms, an ownership change may result from transactions increasing the ownership of certain stockholders in the stock of a corporation by more than 50 percentage points over a three-year period. In the event that an ownership change should occur, utilization of Continental's NOLs would be subject to an annual limitation under Section 382 determined by multiplying the value of the Company's stock at the time of the ownership change by the applicable long-term tax exempt rate (which was 4.71% for February 1999). Any unused annual limitation may be carried over to later years, and the amount of the limitation may under certain circumstances be increased by the built-in gains in assets held by the Company at the time of the change that are recognized in the five-year period after the change. Under current conditions, if an ownership change were to occur, Continental's annual NOL utilization would be limited to approximately $102 million per year other than through the recognition of future built-in gain transactions.

On November 20, 1998, an affiliate of Northwest Airlines, Inc. ("Northwest") completed its acquisition of certain equity of the Company previously held by Air Partners, L.P. ("Air Partners") and its affiliates, together with certain Class A common stock of the Company held by certain other investors, totaling 8,661,224 shares of the Class A common stock (the "Air Partners Transaction"). Based on information currently available, the Company does not believe that the Air Partners Transaction resulted in an ownership change for purposes of Section 382.

*Purchase Commitments.* Continental has substantial commitments for capital expenditures, including for the acquisition of new aircraft. As of February 8, 1999, Continental had agreed to acquire a total of 109 Boeing jet aircraft through 2005. The Company anticipates taking delivery of 57 Boeing jet aircraft in 1999. Continental also has options for an additional 114 aircraft (exercisable subject to certain conditions). The estimated aggregate cost of the Company's firm commitments for Boeing aircraft is approximately $5.4 billion. Continental currently plans to finance its new Boeing aircraft with a combination of enhanced pass through trust certificates, lease equity and other third party financing, subject to availability and market conditions. As of February 8, 1999, Continental had approximately $1.1 billion in financing arranged for such future Boeing deliveries. In addition, Continental has commitments or letters of intent for backstop financing for approximately one-third of the anticipated remaining acquisition cost of such Boeing deliveries. In addition, at February 8, 1999, Continental has firm commitments to purchase 32 spare engines related to the new Boeing aircraft for approximately $167 million which will be deliverable through December 2004. Additional financing will be needed to satisfy the Company's capital commitments for other aircraft and aircraft-related expenditures such as engines, spare parts, simulators and related items. There can be no assurance that sufficient financing will be available for all aircraft and other capital expenditures not covered by firm financing commitments. Deliveries of new Boeing aircraft are expected to increase aircraft rental, depreciation and interest costs while generating cost savings in the areas of maintenance, fuel and pilot training.

As of February 8, 1999, Express had firm commitments for 37 Embraer ERJ-145 ("ERJ-145") regional jets and 25 Embraer ERJ-135 ("ERJ-135") regional jets, with options for an additional 125 ERJ-145 and 50 ERJ-135 aircraft exercisable through 2008. Express anticipates taking delivery of 19 ERJ-145 and six ERJ-135 regional jets in 1999. Neither Express nor Continental will have any obligation to take any of the firm ERJ-145 aircraft that are not financed by a third party and leased to Continental.

Continental expects its cash outlays for 1999 capital expenditures, exclusive of fleet plan requirements, to aggregate $254 million, primarily relating to mainframe, software application and automation infrastructure projects, aircraft modifications and mandatory maintenance projects, passenger terminal facility improvements and office, maintenance, telecommunications and ground equipment. Continental's capital expenditures during 1998 aggregated $179 million, exclusive of fleet plan requirements.

The Company expects to fund its future capital commitments through internally generated funds together with general Company financings and aircraft financing transactions. However, there can be no assurance that sufficient financing will be available for all aircraft and other capital expenditures not covered by firm financing commitments.

*Year 2000 and Euro*. The Year 2000 issue arises as a result of computer programs having been written using two digits (rather than four) to define the applicable year, among other problems. Any information technology ("IT") systems that have time-sensitive software might recognize a date using "00" as the year 1900 rather than the year 2000, which could result in miscalculations and system failures. The problem also extends to many "non-IT" systems; that is, operating and control systems that rely on embedded chip systems. In addition, the Company is at risk from Year 2000 failures on the part of third-party suppliers and governmental agencies with which the Company interacts.

The Company uses a significant number of computer software programs and embedded operating systems that are essential to its operations. For this reason, the Company implemented a Year 2000 project in late 1996 so that the Company's computer systems would function properly in the year 2000 and thereafter. The Company's Year 2000 project involves the review of a number of internal and third-party systems. Each system is subjected to the project's five phases which consist of systems inventory, evaluation and analysis, modification implementation, user testing and integration compliance. The systems are currently in various stages of completion. The Company anticipates completing its review of systems in the second quarter of 1999 and believes that, with modifications to its existing software and systems and/or conversions to new software, the Year 2000 Issue will not pose significant operational problems for its computer systems.

The Company has also initiated communications and on-site visits with its significant suppliers, vendors and governmental agencies with which its systems interface and exchange data or upon which its business depends. The Company is coordinating efforts with these parties to minimize the extent to which its business may be vulnerable to their failure to remediate their own Year 2000 problems. The Company's business is dependent upon certain domestic and foreign governmental organizations or entities such as the Federal Aviation Administration ("FAA") that provide essential aviation industry infrastructure. There can be no assurance that the systems of such third parties on which the Company's business relies (including those of the FAA) will be modified on a timely basis. The Company's business, financial condition or results of operations could be materially adversely affected by the failure of its equipment or systems or those operated by other parties to operate properly beyond 1999. Although the Company currently has day-to-day operational contingency plans, management is in the process of updating these plans for possible Year 2000-specific operational requirements. The Company anticipates completing the revision of current contingency plans and the creation of additional contingency plans by September 1999. In addition, the Company will continue to monitor third-party (including governmental) readiness and will modify its contingency plans accordingly. While the Company does not currently expect any significant modification of its operations in response to the Year 2000 issue, in a worst-case scenario the Company could be required to alter its operations significantly.

The total cost of the Company's Year 2000 project (excluding internal payroll) is currently estimated at $16-18 million and has been and will be funded through cash from operations. As of December 31, 1998, the Company had incurred and expensed approximately $15 million relating to its Year 2000 project. The cost of the Year 2000 project is limited by the substantial outsourcing of the Company's systems and the significant implementation of new systems following the Company's emergence from bankruptcy. The costs of the Company's Year 2000 project and the date on which the Company believes it will be completed are based on management's best estimates and include assumptions regarding third-party modification plans. However, in particular due to the potential impact of third-party modification plans, there can be no assurance that these estimates will be achieved and actual results could differ materially from those anticipated.

Effective January 1, 1999, eleven of the fifteen countries comprising the European Union began a transition to a single monetary unit, the "euro", which is scheduled to be completed by July 1, 2002. The Company has developed processes designed to allow it to effectively operate in euros. Management does not anticipate that the implementation of this single currency plan will have a material effect on the Company's operations or financial condition.

*Bond Financings*. In July 1996, the Company announced plans to expand its gates and related facilities into Terminal B at Bush Intercontinental Airport, as well as planned improvements at Terminal C and the construction of a new automated people mover system linking Terminal B and Terminal C. In April 1997 and January 1999, the City of Houston completed the offering of $190 million and $46 million, respectively, aggregate principal amount of tax-exempt special facilities revenue bonds (the "IAH Bonds"). The IAH Bonds are unconditionally guaranteed by Continental. In connection therewith, the Company has entered into long-term leases (or amendments to existing leases) with the City of Houston providing for the Company to make rental payments sufficient to service the related tax-exempt bonds, which have a term no longer than 30 years. The majority of the Company's expansion project is expected to be completed during the summer of 1999.

In 1998, Continental completed construction of a new hangar and improvements to a cargo facility at Continental's hub at Newark International Airport ("Newark"). Continental completed the financing of these projects in April 1998 with $23 million of tax-exempt bonds issued by the New Jersey Economic Development Authority. Continental is also planning a major facility expansion at Newark which would require, among other matters, agreements to be reached with the applicable airport authority and significant tax-exempt bond financing for the project.

In 1998, the Company built a wide-body aircraft maintenance hangar in Honolulu, Hawaii at an approximate cost of $25 million. Construction of the hangar was financed by tax-exempt special facilities revenue bonds issued by the State of Hawaii. In connection therewith, the Company has entered into long-term leases providing for the Company to make rental payments sufficient to service the related tax-exempt bonds.

Continental has commenced the expansion of its facilities at its Hopkins International Airport hub in Cleveland, which expansion is expected to be completed in the third quarter of 1999. The expansion, which will include a new jet concourse for the regional jet service offered by Express, as well as other facility improvements, is expected to cost approximately $156 million and is being funded principally by a combination of tax-exempt special facilities revenue bonds (issued in March 1998) and general airport revenue bonds (issued in December 1997) by the City of Cleveland. In connection therewith, Continental has entered into a long-term lease with the City of Cleveland under which rental payments will be sufficient to service the related bonds.

*Employees.* In September 1997, the Company announced a plan to bring all employees to industry standard wages no later than the end of the year 2000. Wage increases began in 1997, and will continue to be phased in through 2000 as revenue, interest rates and rental rates reach industry standards.

The following is a table of the Company's, Express's and CMI's principal collective bargaining agreements, and their respective amendable dates:

| Employee Group | Approximate Number of Employees | Representing Union | Contract Amendable Date |
|---|---|---|---|
| Continental Pilots | 5,050 | Independent Association of Continental Pilots | October 2002 |
| Express Pilots | 1,100 | Independent Association of Continental Pilots | October 2002 |
| Dispatchers | 150 | Transport Workers Union of America | October 2003 |
| Continental Mechanics | 3,220 | International Brotherhood of Teamsters | January 2002 |
| Express Mechanics | 280 | International Brotherhood of Teamsters | (Negotiations for initial contract ongoing) |
| CMI Mechanics | 150 | International Brotherhood of Teamsters | March 2001 |
| Continental Flight Attendants | 6,925 | International Association of Machinists and Aerospace Workers | December 1999 |
| Express Flight Attendants | 375 | International Association of Machinists and Aerospace Workers | November 1999 |
| CMI Flight Attendants | 450 | International Association of Machinists and Aerospace Workers | June 2000 |
| CMI Fleet and Passenger Service Employees | 300 | International Brotherhood of Teamsters | March 2001 |

The other employees of Continental, Express and CMI are not covered by collective bargaining agreements.

*Other.* As a result of the decline of the yen against the dollar, a weak Japanese economy and increased fuel costs, CMI's operating earnings declined during 1996 and 1997. Although CMI's results in Asia have declined significantly in recent years, the Company successfully redeployed CMI capacity into the stronger domestic markets and CMI's most recent results have improved.

In addition, the Company has entered into petroleum call option contracts, petroleum swap contracts and jet fuel purchase commitments to provide some short-term protection (generally three to six months) against a sharp increase in jet fuel prices, and has entered into forward contracts and purchased foreign currency average rate option contracts to hedge a portion of its Japanese yen-denominated ticket sales against a significant depreciation in the value of the yen versus the United States dollar.

During 1998, Continental began block-space arrangements whereby it is committed to purchase capacity on other carriers at an aggregate cost of approximately $150 million per year. These arrangements are for 10 years. Pursuant to other block-space arrangements, other carriers are committed to purchase capacity at a cost of approximately $100 million on Continental.

Management believes that the Company's costs are likely to be affected in the future by (i) higher aircraft rental expense as new aircraft are delivered, (ii) higher wages, salaries and related costs as the Company compensates its employees comparable to industry average, (iii) changes in the costs of materials and services (in particular, the cost of fuel, which can fluctuate significantly in response to global market conditions), (iv) changes in governmental regulations and taxes affecting air transportation and the costs charged for airport access, including new security requirements, (v) changes in the Company's fleet and related capacity and (vi) the Company's continuing efforts to reduce costs throughout its operations, including reduced maintenance costs for new aircraft, reduced distribution expense from using Continental's electronic ticket product, E-Ticket and the Internet for bookings, and reduced interest expense.

# Quantitative and Qualitative Disclosures About Market Risk

## Market Risk Sensitive Instruments and Positions

The Company is subject to certain market risks, including commodity price risk (i.e., aircraft fuel prices), interest rate risk, foreign currency risk and price changes related to investments in equity securities. The adverse effects of potential changes in these market risks are discussed below. The sensitivity analyses presented do not consider the effects that such adverse changes may have on overall economic activity nor do they consider additional actions management may take to mitigate the Company's exposure to such changes. Actual results may differ. See the notes to the consolidated financial statements for a description of the Company's accounting policies and other information related to these financial instruments.

*Aircraft Fuel.* The Company's results of operations are significantly impacted by changes in the price of aircraft fuel. During 1998, aircraft fuel accounted for 10.2% of the Company's operating expenses (excluding fleet disposition/impairment loss). Based on the Company's 1999 projected fuel consumption, a one cent change in the average annual price per gallon of aircraft fuel would impact the Company's annual aircraft fuel expense by approximately $12 million, after the effect of hedging instruments and jet fuel purchase commitments in place as of December 31, 1998. In order to provide short-term protection (generally three to six months), the Company has entered into petroleum call options, petroleum swap contracts and jet fuel purchase commitments. The Company's fuel hedging strategy could result in the Company not fully benefiting from certain fuel price declines. As of December 31, 1998, the Company had hedged approximately 25% of its projected 1999 fuel requirements, including 93% related to the first quarter and 9% related to the second quarter using petroleum swap contracts. The Company estimates that at December 31, 1998, a ten percent change in the price per gallon of aircraft fuel would have changed the fair value of the existing petroleum swap contracts by $8 million.

*Foreign Currency.* The Company is exposed to the effect of exchange rate fluctuations on the U.S. dollar value of foreign currency denominated operating revenue and expenses. The Company's largest exposure comes from the Japanese yen. The result of a uniform 25% strengthening in the value of the U.S. dollar from December 31, 1998 levels relative to the yen would result in an estimated decrease in operating income of approximately $13 million for 1999, after the effect of hedging instruments in place. However, the Company is attempting to mitigate the effect of certain potential foreign currency losses by purchasing foreign currency average rate option contracts and entering into forward contracts that effectively enable it to sell Japanese yen expected to be received from yen-denominated ticket sales over the next nine to twelve months at specified dollar amounts. As of December 31, 1998, the Company had purchased average rate options and entered into forward contracts to hedge approximately 100% of its first and second quarter 1999 projected net yen-denominated cash flows and 75% of its third quarter 1999 projected net yen-denominated cash flows. The Company estimates that at December 31, 1998, a 25% strengthening in the value of the U.S. dollar relative to the yen would have increased the fair value of the existing average rate options and forward contracts by $22 million.

*Interest Rates.* The Company's results of operations are affected by fluctuations in interest rates (e.g., interest expense on debt and interest income earned on short-term investments).

The Company had approximately $599 million of variable-rate debt as of December 31, 1998. The Company has mitigated its exposure on certain variable-rate debt by entering into an interest rate cap (notional amount of $125 million as of December 31, 1998) which expires in July 2001. The interest rate cap limits the amount of potential increase in the LIBOR rate component of the floating rate to a maximum of 9% over the term of the contract. If average interest rates increased by 1.0% during 1999 as compared to 1998, the Company's projected 1999 interest expense would increase by approximately $5 million. The interest rate cap does not mitigate this increase in interest expense materially.

As of December 31, 1998, the fair value of $1.52 billion (carrying value) of the Company's fixed-rate debt was estimated to be $1.47 billion, based upon discounted future cash flows using current incremental borrowing rates for similar types of instruments or market prices. Market risk, estimated as the potential increase in fair value resulting from a hypothetical 1.0% decrease in interest rates, was approximately $70 million as of December 31, 1998. The fair value of the remaining fixed-rate debt (with a carrying value of $287 million and primarily relating to aircraft modification notes and various loans with immaterial balances) was not practicable to estimate due to the large number and small dollar amounts of these notes.

If 1999 average short-term interest rates decreased by 1.0% over 1998 average rates, the Company's projected interest income from short-term investments would decrease by approximately $13 million during 1999.

*Investments in Equity Securities.* Continental's investment in America West Holdings at December 31, 1998, which was recorded at its fair value of $3 million and includes unrealized gains of $1 million, has exposure to price risk. This risk is estimated as the potential loss in fair value resulting from a hypothetical 10% adverse change in prices quoted by stock exchanges and amounts to less than $1 million.

The Company also has a 12.4% investment in AMADEUS Global Travel Distribution S.A. ("AMADEUS") and a 49% equity investment in Compania Panamena de Aviacion, S.A. ("COPA") which are also subject to price risk. However, since a readily determinable market value does not exist for either AMADEUS or COPA (each is privately held), the Company is unable to quantify the amount of price risk sensitivity inherent in these investments. At December 31, 1998, the carrying value of these investments was $95 million and $53 million, respectively. At December 31, 1997, the carrying value of AMADEUS was $95 million.

# Consolidated Statements of Operations

(In millions, except per share data)

| | Year Ended December 31, 1998 | 1997 | 1996 |
|---|---|---|---|
| Operating Revenue: | | | |
| Passenger | $ 7,366 | $ 6,660 | $ 5,871 |
| Cargo and mail | 275 | 258 | 232 |
| Other | 310 | 295 | 257 |
| | 7,951 | 7,213 | 6,360 |
| Operating Expenses: | | | |
| Wages, salaries and related costs | 2,218 | 1,814 | 1,549 |
| Aircraft fuel | 727 | 885 | 774 |
| Aircraft rentals | 659 | 551 | 509 |
| Commissions | 583 | 567 | 510 |
| Maintenance, materials and repairs | 582 | 537 | 461 |
| Other rentals and landing fees | 414 | 395 | 350 |
| Depreciation and amortization | 294 | 254 | 254 |
| Fleet disposition/impairment losses: | | | |
| Jet | 65 | — | 128 |
| Turboprop | 57 | — | — |
| Other | 1,651 | 1,494 | 1,300 |
| | 7,250 | 6,497 | 5,835 |
| Operating Income | 701 | 716 | 525 |
| Nonoperating Income (Expense): | | | |
| Interest expense | (178) | (166) | (165) |
| Interest income | 59 | 56 | 43 |
| Interest capitalized | 55 | 35 | 5 |
| Other, net | 11 | (1) | 20 |
| | (53) | (76) | (97) |
| Income before Income Taxes, Minority Interest and Extraordinary Charge | 648 | 640 | 428 |
| Income Tax Provision | (248) | (237) | (86) |
| Income before Minority Interest and Extraordinary Charge | 400 | 403 | 342 |
| Minority Interest | — | — | (3) |
| Distributions on Preferred Securities of Trust, net of applicable income taxes of $7, $8 and $8, respectively | (13) | (14) | (14) |
| Income before Extraordinary Charge | 387 | 389 | 325 |
| Extraordinary Charge, net of applicable income taxes of $2, $2 and $4, respectively | (4) | (4) | (6) |
| Net Income | 383 | 385 | 319 |
| Preferred Dividend Requirements and Accretion to Liquidation Value | — | (2) | (5) |
| Income Applicable to Common Shares | $ 383 | $ 383 | $ 314 |
| Earnings per Common Share: | | | |
| Income before Extraordinary Charge | $ 6.40 | $ 6.72 | $ 5.87 |
| Extraordinary Charge | (0.06) | (0.07) | (0.12) |
| Net Income | $ 6.34 | $ 6.65 | $ 5.75 |
| Earnings per Common Share Assuming Dilution: | | | |
| Income before Extraordinary Charge | $ 5.06 | $ 5.03 | $ 4.25 |
| Extraordinary Charge | (0.04) | (0.04) | (0.08) |
| Net Income | $ 5.02 | $ 4.99 | $ 4.17 |

The accompanying Notes to Consolidated Financial Statements are an integral part of these statements.

# Consolidated Balance Sheets

(In millions, except for share data)

| Assets | December 31, 1998 | December 31, 1997 |
|---|---|---|
| Current Assets: | | |
| Cash and cash equivalents, including restricted cash and cash equivalents of $11 and $15, respectively | $ 1,399 | $ 1,025 |
| Accounts receivable, net of allowance for doubtful receivables of $22 and $23, respectively | 449 | 361 |
| Spare parts and supplies, net of allowance for obsolescence of $46 and $51, respectively | 166 | 128 |
| Deferred income taxes | 234 | 111 |
| Prepayments and other assets | 106 | 103 |
| Total current assets | 2,354 | 1,728 |
| Property and Equipment: | | |
| Owned property and equipment: | | |
| Flight equipment | 2,459 | 1,636 |
| Other | 582 | 456 |
| | 3,041 | 2,092 |
| Less: Accumulated depreciation | 625 | 473 |
| | 2,416 | 1,619 |
| Purchase deposits for flight equipment | 410 | 437 |
| Capital leases: | | |
| Flight equipment | 361 | 274 |
| Other | 56 | 40 |
| | 417 | 314 |
| Less: Accumulated amortization | 178 | 145 |
| | 239 | 169 |
| Total property and equipment | 3,065 | 2,225 |
| Other Assets: | | |
| Routes, gates and slots, net of accumulated amortization of $283 and $270, respectively | 1,181 | 1,425 |
| Reorganization value in excess of amounts allocable to identifiable assets, net of accumulated amortization of $71 in 1997 | — | 164 |
| Investments | 151 | 104 |
| Other assets, net | 335 | 184 |
| Total other assets | 1,667 | 1,877 |
| Total Assets | $ 7,086 | $ 5,830 |

| Liabilities and Stockholders' Equity | December 31, 1998 | December 31, 1997 |
|---|---|---|
| **Current Liabilities:** | | |
| Current maturities of long-term debt | $ 184 | $ 243 |
| Current maturities of capital leases | 47 | 40 |
| Accounts payable | 843 | 781 |
| Air traffic liability | 854 | 746 |
| Accrued payroll and pensions | 265 | 158 |
| Accrued other liabilities | 249 | 317 |
| Total current liabilities | 2,442 | 2,285 |
| Long-Term Debt | 2,267 | 1,426 |
| Capital Leases | 213 | 142 |
| **Deferred Credits and Other Long-Term Liabilities:** | | |
| Deferred income taxes | 372 | 435 |
| Accruals for aircraft retirements and excess facilities | 95 | 123 |
| Other | 393 | 261 |
| Total deferred credits and other long-term liabilities | 860 | 819 |
| Commitments and Contingencies | | |
| Continental-Obligated Mandatorily Redeemable Preferred Securities of Subsidiary Trust Holding Solely Convertible Subordinated Debentures (1) | 111 | 242 |
| **Common Stockholders' Equity:** | | |
| Class A common stock - $.01 par, 50,000,000 shares authorized; 11,406,732 shares issued and outstanding in 1998 and 8,379,464 shares issued and outstanding in 1997 | — | — |
| Class B common stock - $.01 par, 200,000,000 shares authorized; 53,370,741 shares issued in 1998 and 50,512,010 shares issued and outstanding in 1997 | 1 | 1 |
| Additional paid-in capital | 634 | 641 |
| Retained earnings | 659 | 276 |
| Accumulated other comprehensive income | (88) | (2) |
| Treasury Stock - 399,524 Class B shares in 1998, at cost | (13) | — |
| Total common stockholders' equity | 1,193 | 916 |
| Total Liabilities and Stockholders' Equity | $ 7,086 | $ 5,830 |

(1) The sole assets of the Trust were convertible subordinated debentures. At December 31, 1998 and 1997, the debentures had an aggregate principal amount of $115 and $249 million, respectively, bore interest at the rate of 8-1/2% per annum and were to mature on December 1, 2020. In November and December 1998, approximately $134 million of such securities converted into 5,558,649 shares of Class B common stock, and in January 1999, the remainder of such securities were converted into 4,752,522 shares of Class B common stock.

The accompanying Notes to Consolidated Financial Statements are an integral part of these statements.

# Consolidated Statements of Cash Flows

(In millions)

| | Year Ended December 31, 1998 | 1997 | 1996 |
|---|---|---|---|
| **Cash Flows From Operating Activities:** | | | |
| Net income | $ 383 | $ 385 | $ 319 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Deferred income taxes | 241 | 212 | 72 |
| Depreciation | 211 | 162 | 153 |
| Fleet disposition/impairment losses | 122 | — | 128 |
| Amortization | 83 | 92 | 101 |
| Other, net | (4) | 34 | 11 |
| Changes in operating assets and liabilities: | | | |
| Increase in air traffic liability | 108 | 85 | 82 |
| Increase in accounts receivable | (102) | (1) | (42) |
| Increase in spare parts and supplies | (71) | (38) | (43) |
| Increase in accounts payable | 59 | 71 | 103 |
| Other | (150) | (42) | (53) |
| Net cash provided by operating activities | 880 | 960 | 831 |
| **Cash Flows from Investing Activities:** | | | |
| Purchase deposits paid in connection with future aircraft deliveries | (818) | (409) | (116) |
| Purchase deposits refunded in connection with aircraft delivered | 758 | 141 | 20 |
| Capital expenditures, net of returned purchase deposits in 1996 | (610) | (417) | (198) |
| Investment in partner airline | (53) | — | — |
| Proceeds from disposition of property and equipment | 46 | 29 | 11 |
| Other | (21) | (1) | 32 |
| Net cash used by investing activities | (698) | (657) | (251) |
| **Cash Flows From Financing Activities:** | | | |
| Proceeds from issuance of long-term debt, net | 737 | 517 | 797 |
| Payments on long-term debt and capital lease obligations | (423) | (676) | (975) |
| Purchase of Class B treasury stock | (223) | — | — |
| Proceeds from sale-leaseback transactions | 71 | 39 | 47 |
| Proceeds from issuance of common stock | 56 | 24 | 18 |
| Dividends paid on preferred securities of trust | (22) | (22) | (22) |
| Purchase of warrants to purchase Class B common stock | — | (94) | (50) |
| Redemption of preferred stock | — | (48) | — |
| Other | — | (18) | (13) |
| Net cash provided (used) by financing activities | 196 | (278) | (198) |
| Net Increase in Cash and Cash Equivalents | 378 | 25 | 382 |
| Cash and Cash Equivalents Beginning of Period (1) | 1,010 | 985 | 603 |
| Cash and Cash Equivalents End of Period (1) | $ 1,388 | $ 1,010 | $ 985 |

| | Year Ended December 31, 1998 | | 1997 | | 1996 | |
|---|---|---|---|---|---|---|
| Supplemental Cash Flows Information: | | | | | | |
| Interest paid | $ | 157 | $ | 156 | $ | 161 |
| Income taxes paid | $ | 25 | $ | 12 | $ | 4 |
| Financing and Investing Activities Not Affecting Cash: | | | | | | |
| Property and equipment acquired through the issuance of debt | $ | 425 | $ | 207 | $ | 119 |
| Conversion of trust originated preferred securities | $ | 134 | $ | — | $ | — |
| Capital lease obligations incurred | $ | 124 | $ | 22 | $ | 32 |
| Reduction of capital lease obligations in connection with refinanced aircraft | $ | — | $ | 97 | $ | — |
| Financed purchase deposits for flight equipment, net | $ | — | $ | 14 | $ | 19 |

(1) Excludes restricted cash of $11 million, $15 million, $76 million and $144 million at December 31, 1998, 1997, 1996 and 1995, respectively.

The accompanying Notes to Consolidated Financial Statements are an integral part of these statements.

# Consolidated Statements of Redeemable Preferred Stock and Common Stockholders' Equity

(In millions)

| | Redeemable Preferred Stock | Additional Paid-In Capital | Retained Earnings (Accumulated Deficit) | Accumulated Other Comprehensive Income | Comprehensive Income | Treasury Stock, at Cost |
|---|---|---|---|---|---|---|
| Balance, December 31, 1995 | $ 41 | $ 723 | $ (428) | $ 10 | $ — | $ — |
| Net Income | — | — | 319 | — | 319 | — |
| Purchase of Warrants | — | (50) | — | — | — | — |
| Accumulated Dividends on Series A 12% Cumulative Preferred Stock | 5 | (5) | — | — | — | — |
| Additional Minimum Pension Liability, net of applicable income taxes of $2 | — | — | — | 6 | 6 | — |
| Unrealized Gain on Marketable Equity Securities, net of applicable income taxes of $1 | — | — | — | 4 | 4 | — |
| Reclassification to realized gains | — | — | — | (18) | — | — |
| Other | — | 20 | — | — | — | — |
| Balance, December 31, 1996 | 46 | 688 | (109) | 2 | 329 | — |
| Net Income | — | — | 385 | — | 385 | — |
| Purchase of Warrants | — | (94) | — | — | — | — |
| Accumulated Dividends on Series A 12% Cumulative Preferred Stock | 2 | (2) | — | — | — | — |
| Redemption of Series A 12% Cumulative Preferred Stock | (48) | — | — | — | — | — |
| Additional Minimum Pension Liability, net of applicable income taxes of $2 | — | — | — | (4) | (4) | — |
| Other | — | 49 | — | — | — | — |
| Balance, December 31, 1997 | — | 641 | 276 | (2) | 381 | — |
| Net Income | — | — | 383 | — | 383 | — |
| Cumulative Effect of Adopting SFAS 133 (see Note 5) as of October 1, 1998, net of applicable income taxes of $1 | — | — | — | 1 | 1 | — |
| Net loss on derivative instruments designated and qualifying as cash flow hedging instruments, net of applicable income taxes of $4 | — | — | — | (7) | (7) | — |
| Additional Minimum Pension Liability, net of applicable income taxes of $41 | — | — | — | (76) | (76) | — |
| Unrealized Gain on Marketable Equity Securities, net of applicable income taxes of $1 | — | — | — | (4) | (4) | — |
| Purchase of Common Stock | — | — | — | — | — | (223) |
| Reissuance of Treasury Stock pursuant to Stock Plans | — | — | — | — | — | 50 |
| Issuance of Common Stock pursuant to Stock Plans | — | 9 | — | — | — | — |
| Conversion of Trust Originated Preferred Securities into Common Stock | — | (32) | — | — | — | 160 |
| Other | — | 16 | — | — | — | — |
| Balance, December 31, 1998 | $ — | $ 634 | $ 659 | $ (88) | $ 297 | $ (13) |

# Consolidated Statements of Redeemable Preferred Stock and Common Stockholders' Equity

Number of Shares

| | Redeemable Preferred Stock | Class A Common Stock | Class B Common Stock | Treasury Stock |
|---|---|---|---|---|
| Balance, December 31, 1995 | 397,948 | 12,602,112 | 42,856,548 | — |
| Conversion of Class A to Class B Common Stock by Air Canada | — | (3,322,112) | 3,322,112 | — |
| Forfeiture of Restricted Class B Common Stock | — | — | (60,000) | 60,000 |
| Purchase of Common Stock | — | — | (133,826) | 133,826 |
| Reissuance of Treasury Stock | — | — | 193,826 | (193,826) |
| Preferred Stock In-kind Dividend | 49,134 | — | — | — |
| Issuance of Common Stock pursuant to Stock Plans and Awards | — | — | 1,764,683 | — |
| Balance, December 31, 1996 | 447,082 | 9,280,000 | 47,943,343 | — |
| Conversion of Class A to Class B Common Stock | — | (900,536) | 900,536 | — |
| Purchase of Common Stock | — | — | (154,882) | 154,882 |
| Reissuance of Treasury Stock pursuant to Stock Plans | — | — | 154,882 | (154,882) |
| Issuance of Preferred Stock Dividends on Series A 12% Cumulative Preferred Stock | 13,165 | — | — | — |
| Redemption of Series A 12% Cumulative Preferred Stock | (460,247) | — | — | — |
| Issuance of Common Stock pursuant to Stock Plans | — | — | 1,646,419 | — |
| Conversion of Trust Originated Preferred Securities into Common Stock | — | — | 21,712 | — |
| Balance, December 31, 1997 | — | 8,379,464 | 50,512,010 | — |
| Purchase of Common Stock | — | — | (4,452,700) | 4,452,700 |
| Reissuance of Treasury Stock pursuant to Stock Plans | — | — | 859,080 | (859,080) |
| Reissuance of Treasury Stock pursuant to Conversion of Trust Originated Preferred Securities | — | — | 3,181,896 | (3,181,896) |
| Conversion of Class A to Class B Common Stock | — | (12,200) | 12,200 | (12,200) |
| Issuance of Common Stock pursuant to Stock Plans | — | — | 235,290 | — |
| Conversion of Trust Originated Preferred Securities into Common Stock | — | — | 2,376,753 | — |
| Exercise of warrants | — | 3,039,468 | 246,688 | — |
| Balance, December 31, 1998 | — | 11,406,732 | 52,971,217 | 399,524 |

The accompanying Notes to Consolidated Financial Statements are an integral part of these statements.

# Notes to Consolidated Financial Statements

Continental Airlines, Inc. (the "Company" or "Continental") is a major United States air carrier engaged in the business of transporting passengers, cargo and mail. Continental is the fifth largest United States airline (as measured by 1998 revenue passenger miles) and, together with its wholly owned subsidiaries, Continental Express, Inc. ("Express"), and Continental Micronesia, Inc. ("CMI"), each a Delaware corporation, serves 206 airports worldwide on December 31, 1998. As of December 31, 1998, Continental flies to 127 domestic and 79 international destinations and offers additional connecting service through alliances with domestic and foreign carriers. Continental directly serves 13 European cities, eight South American cities and is one of the leading airlines providing service to Mexico and Central America, serving more destinations there than any other United States airline. Through its Guam hub, CMI provides extensive service in the western Pacific, including service to more Japanese cities than any other United States carrier.

As used in these Notes to Consolidated Financial Statements, the terms "Continental" and "Company" refer to Continental Airlines, Inc. and, unless the context indicates otherwise, its subsidiaries.

## Note 1 — Summary of Significant Accounting Policies

**(a) Principles of Consolidation —**

The consolidated financial statements of the Company include the accounts of Continental and its operating subsidiaries, Express and CMI. All significant intercompany transactions have been eliminated in consolidation.

**(b) Use of Estimates —**

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

**(c) Cash and Cash Equivalents —**

Cash and cash equivalents consist of cash and short-term, highly liquid investments which are readily convertible into cash and have a maturity of three months or less when purchased. Approximately $11 million and $15 million of cash and cash equivalents at December 31, 1998 and 1997, respectively, were held in restricted arrangements relating primarily to payments for workers' compensation claims and in accordance with the terms of certain other agreements.

**(d) Spare Parts and Supplies —**

Flight equipment expendable parts and supplies are valued at average cost. An allowance for obsolescence for flight equipment expendable parts and supplies is accrued to allocate the costs of these assets, less an estimated residual value, over the estimated useful lives of the related aircraft and engines.

**(e) Property and Equipment —**

Property and equipment were recorded at fair market values as of April 27, 1993. Subsequent purchases were recorded at cost and are depreciated to estimated residual values over their estimated useful lives using the straight-line method. Effective January 1, 1998, the Company increased the depreciable life on certain new generation Boeing aircraft from 25 to 30 years. The Company also increased the estimated residual values on certain Stage 3 and new generation Boeing aircraft from 10% to 15%. All owned turboprop aircraft are depreciated over an 18-year useful life with an estimated residual value of 10%. Flight and ground equipment under capital leases are depreciated on a straight-line method over the respective original lease terms. Ground property and equipment, including airport facility improvements, are depreciated on a straight-line method from 2 to 25 years.

**(f) Intangible Assets —**

During 1998, the Company determined that it would be able to recognize additional net operating losses ("NOLs") attributable to the Company's predecessor as a result of the completion of several transactions resulting in recognition of built-in gains for federal income tax purposes. This benefit was used to reduce to zero reorganization value in excess of amounts allocable to identifiable assets in the first quarter of 1998. During the third and fourth quarters of 1998, the Company determined that additional NOLs of the Company's predecessor could be benefitted and accordingly reduced the deferred tax valuation allowance and routes, gates and slots by $190 million.

*Routes, Gates and Slots*

Routes are amortized on a straight-line basis over 40 years, gates over the stated term of the related lease and slots over 20 years. Routes, gates and slots are comprised of the following (in millions):

| | Balance at December 31, 1998 | Accumulated Amortization at December 31, 1998 |
|---|---|---|
| Routes | $ 754 | $ 123 |
| Gates | 327 | 120 |
| Slots | 100 | 40 |
| | $1,181 | $ 283 |

*Reorganization Value In Excess of Amounts Allocable to Identifiable Assets*

Reorganization value in excess of amounts allocable to identifiable assets, arising from Continental's emergence from bankruptcy reorganization in 1993, was amortized on a straight-line basis over 20 years.

**(g) Air Traffic Liability —**

Passenger revenue is recognized when transportation is provided rather than when a ticket is sold. The amount of passenger ticket sales not yet recognized as revenue is reflected in the accompanying Consolidated Balance Sheets as air traffic liability. The Company performs periodic evaluations of this estimated liability, and any adjustments resulting therefrom, which can be significant, are included in results of operations for the periods in which the evaluations are completed.

Continental sponsors a frequent flyer program ("OnePass") and records an estimated liability for the incremental cost associated with providing the related free transportation at the time a free travel award is earned. The liability is adjusted periodically based on awards earned, awards redeemed and changes in the OnePass program.

The Company also sells mileage credits in the OnePass program to participating partners in the OnePass program, such as hotels, car rental agencies and credit card companies. The resulting revenue, net of the estimated incremental cost of the credits sold, is recorded in the accompanying Consolidated Statements of Operations during the period in which the credits are sold as other operating revenue.

**(h) Passenger Traffic Commissions —**

Passenger traffic commissions are recognized as expense when the transportation is provided and the related revenue is recognized. The amount of passenger traffic commissions not yet recognized as expense is included in Prepayments and other assets in the accompanying Consolidated Balance Sheets.

**(i) Deferred Income Taxes —**

Deferred income taxes are provided under the liability method and reflect the net tax effects of temporary differences between the tax basis of assets and liabilities and their reported amounts in the financial statements.

**(j) Maintenance and Repair Costs —**

Maintenance and repair costs for owned and leased flight equipment, including the overhaul of aircraft components, are charged to operating expense as incurred.

**(k) Advertising Costs —**

The Company expenses the costs of advertising as incurred. Advertising expense was $102 million, $98 million and $76 million for the years ended December 31, 1998, 1997 and 1996, respectively.

**(l) Stock Plans and Awards —**

Continental has elected to follow Accounting Principles Board Opinion No. 25 –"Accounting for Stock Issued to Employees" ("APB 25") in accounting for its employee stock options and its stock purchase plans because the alternative fair value accounting provided for under Statement of Financial Accounting Standards No. 123 –"Accounting for Stock-Based Compensation" ("SFAS 123") requires use of option valuation models that were not developed for use in valuing employee stock options or purchase rights. Under APB 25, since the exercise price of the Company's employee stock options equals the market price of the underlying stock on the date of grant, generally no compensation expense is recognized. Furthermore, under APB 25, since the stock purchase plans are considered noncompensatory plans, no compensation expense is recognized.

**(m) Measurement of Impairment —**

In accordance with Statement of Financial Accounting Standards No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of" ("SFAS 121"), the Company records impairment losses on long-lived assets used in operations when events and circumstances indicate that the assets might be impaired and the undiscounted cash flows estimated to be generated by those assets are less than the carrying amount of those assets.

**(n) Recently Issued Accounting Standards —**

Statement of Position 98-5, "Reporting on the Costs of Start-Up Activities" ("SOP 98-5"), requires start-up costs to be expensed as incurred. Continental will adopt SOP 98-5 in the first quarter of 1999. This statement requires all unamortized start up costs (e.g., pilot training costs related to induction of new aircraft) to be expensed upon adoption, resulting in approximately a $5 million cumulative effect of change in accounting, net of tax, in the first quarter of 1999.

**(o) Reclassifications —**

Certain reclassifications have been made in the prior years' financial statements to conform to the current year presentation.

## Note 2 — Earnings Per Share

Basic earnings per common share ("EPS") excludes dilution and is computed by dividing net income available to common stockholders by the weighted average number of common shares outstanding for the period. Diluted EPS reflects the potential dilution that could occur if securities or other obligations to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the entity Company. The following table sets forth the computation of basic and diluted earnings per share (in millions):

| | 1998 | 1997 | 1996 |
|---|---|---|---|
| Numerator: | | | |
| Income before extraordinary charge | $387 | $389 | $325 |
| Extraordinary charge, net of applicable income taxes | (4) | (4) | (6) |
| Net income | 383 | 385 | 319 |
| Preferred stock dividends | — | (2) | (5) |
| Numerator for basic earnings per share — income available to common stockholders | 383 | 383 | 314 |
| Effect of dilutive securities: | | | |
| Preferred Securities of Trust | 11 | 14 | 15 |
| 6¾% convertible subordinated notes | 9 | 11 | 8 |
| Series A convertible debentures | — | — | 1 |
| | 20 | 25 | 24 |
| Other | — | (4) | (3) |
| Numerator for diluted earnings per share — income available to common stockholders after assumed conversions | $403 | $404 | $335 |
| Denominator: | | | |
| Denominator for basic earnings per share — weighted-average shares | 60.3 | 57.6 | 54.6 |
| Effect of dilutive securities: | | | |
| Employee stock options | 1.7 | 1.6 | 2.2 |
| Warrants | 0.9 | 3.5 | 5.9 |
| Preferred Securities of Trust | 9.8 | 10.3 | 10.3 |
| 6¾% convertible subordinated notes | 7.6 | 7.6 | 5.8 |
| Restricted Class B common stock | — | 0.4 | 0.8 |
| Series A convertible debentures | — | — | 0.7 |
| Dilutive potential common shares | 20.0 | 23.4 | 25.7 |
| Denominator for diluted earnings per share — adjusted weighted-average and assumed conversions | 80.3 | 81.0 | 80.3 |

Options to purchase 2,909,130 and 2,643,426 shares of the Company's Class B common stock, par value $.01 per share ("Class B common stock"), during the third and fourth quarters of 1998, respectively, were not included in the computation of diluted earnings per share in 1998 because the options' exercise price was greater than the average market price of the common shares and, therefore, the effect would have been antidilutive.

## Note 3 — Long-Term Debt

Long-term debt as of December 31 is summarized as follows (in millions):

| | 1998 | 1997 |
|---|---|---|
| *Secured* | | |
| Notes payable, interest rates of 5.00% to 7.52%, payable through 2019 | $ 886 | $ 201 |
| Floating rate notes, interest rates of LIBOR plus 0.75% to 1.25%, Eurodollar plus 1.0%, or Commercial Paper, payable through 2009 | 223 | 174 |
| Notes payable, interest rates of 7.13% to 7.15%, payable through 1999 and floating rates thereafter of LIBOR plus 2%, payable through 2011 | 86 | 91 |
| Notes payable, interest rates of 8.0% to 9.97%, payable through 2019 | 66 | 124 |
| Revolving credit facility totaling $160 million, floating interest rates of LIBOR or Eurodollar plus 1.125%, payable through 1999 | 57 | 160 |
| Credit facility, floating interest rate of LIBOR or Eurodollar plus 1.125%, payable through 2002 | — | 275 |
| Floating rate note, interest rate of LIBOR or Eurodollar plus 1.375%, payable through 2004 | — | 75 |
| Notes payable, interest rates of 10.0% to 14.0%, payable through 2005 | — | 54 |
| Floating rate notes, interest rates of LIBOR plus 2.50% to 3.75%, payable through 2005 | — | 30 |
| Other | — | 2 |
| *Unsecured* | | |
| Senior notes payable, 9.5%, payable through 2001 | 250 | 250 |
| Credit facility, floating interest rate of LIBOR or Eurodollar plus 1.125%, payable through 2002 | 245 | — |
| Convertible subordinated notes, interest rate of 6.75%, payable through 2006 | 230 | 230 |
| Senior notes payable, interest rate of 8.0%, payable through 2005 | 200 | — |
| Notes payable, interest rate of 8.125%, payable through 2008 | 110 | — |
| Floating rate note, interest rate of LIBOR or Eurodollar plus 1.375%, payable through 2004 | 74 | — |
| Other | 24 | 3 |
| | 2,451 | 1,669 |
| Less: current maturities | 184 | 243 |
| Total | $2,267 | $1,426 |

At December 31, 1998 and 1997, the LIBOR and Eurodollar rates associated with Continental's indebtedness approximated 5.1% and 5.8% and 5.1% and 5.8%, respectively. The Commercial Paper rate was 5.5% as of December 31, 1998.

A majority of Continental's property and equipment is subject to agreements securing indebtedness of Continental.

In July 1997, Continental entered into a $575 million credit facility (the "Credit Facility"), including a $275 million term loan, the proceeds of which were loaned to CMI to repay its existing $320 million secured term loan. In connection with this prepayment, Continental recorded a $4 million after tax extraordinary charge relating to early extinguishment of debt. The Credit Facility also includes a $225 million revolving credit facility with a commitment fee of 0.25% per annum on the unused portion, and a $75 million term loan commitment with a current floating interest rate of Libor or Eurodollar plus 1.375%. At December 31, 1998 and 1997, no borrowings were outstanding under the $225 million revolving credit facility. During 1998, the Credit Facility became unsecured due to an upgrade of Continental's credit rating by Standard and Poor's Corporation.

The Credit Facility does not contain any financial covenants relating to CMI other than covenants restricting CMI's incurrence of certain indebtedness and pledge or sale of assets. In addition, the Credit Facility contains certain financial covenants applicable to Continental and prohibits Continental from granting a security interest on certain of its international route authorities.

In April 1998, the Company completed an offering of $187 million of pass-through certificates to be used to refinance the debt related to 14 aircraft currently owned by Continental. In connection with this refinancing, Continental recorded a $4 million after tax extraordinary charge to consolidated earnings in the second quarter of 1998 related to the early extinguishment of such debt.

At December 31, 1998, under the most restrictive provisions of the Company's debt and credit facility agreements, the Company had a minimum cash balance requirement of $600 million, a minimum net worth requirement of $758 million and was restricted from paying cash dividends in excess of $533 million.

In March 1996, the Company issued $230 million of 6-3/4% Convertible Subordinated Notes (the "Notes"). The Notes are convertible into shares of Class B common stock prior to their maturity date, April 15, 2006, at a conversion price of $30.195 per share. The Notes are redeemable at the option of the Company on or after April 15, 1999, at specified redemption prices.

Maturities of long-term debt due over the next five years are as follows (in millions):

| Year ending December 31, | |
|---|---|
| 1999 | $ 184 |
| 2000 | 182 |
| 2001 | 419 |
| 2002 | 236 |
| 2003 | 122 |

## Note 4 — Leases

Continental leases certain aircraft and other assets under long-term lease arrangements. Other leased assets include real property, airport and terminal facilities, sales offices, maintenance facilities, training centers and general offices. Most leases also include renewal options, and some aircraft leases include purchase options.

At December 31, 1998, the scheduled future minimum lease payments under capital leases and the scheduled future minimum lease rental payments required under aircraft and engine operating leases, that have initial or remaining noncancellable lease terms in excess of one year, are as follows (in millions):

| | Capital Leases | Operating Leases |
|---|---|---|
| Year ending December 31, | | |
| 1999 | $ 66 | $ 738 |
| 2000 | 55 | 729 |
| 2001 | 56 | 711 |
| 2002 | 30 | 637 |
| 2003 | 24 | 575 |
| Later years | 98 | 4,818 |
| Total minimum lease payments | 329 | $ 8,208 |
| Less: amount representing interest | 69 | |
| Present value of capital leases | 260 | |
| Less: current maturities of capital leases | 47 | |
| Long-term capital leases | $ 213 | |

Not included in the above operating lease table is approximately $404 million of annual average minimum lease payments for each of the next five years relating to non-aircraft leases, principally airport and terminal facilities and related equipment.

Continental is the guarantor of $422 million aggregate principal amount of tax-exempt special facilities revenue bonds. These bonds, issued by various airport municipalities, are payable solely from rentals paid by Continental under long-term agreements with the respective governing bodies.

At December 31, 1998, the Company, including Express, had 350 and 31 aircraft under operating and capital leases, respectively. These leases have remaining lease terms ranging from one month to 21 years.

The Company's total rental expense for all operating leases, net of sublease rentals, was $922 million, $787 million and $719 million in 1998, 1997 and 1996, respectively.

During 1997, the Company acquired 10 aircraft previously leased by it. Aircraft maintenance expense in the second quarter of 1997 was reduced by approximately $16 million due to the reversal of reserves that were no longer required as a result of the transaction.

## Note 5 — Financial Instruments and Risk Management

As part of the Company's risk management program, Continental uses or used a variety of financial instruments, including petroleum call options, petroleum swaps, jet fuel purchase commitments, foreign currency average rate options, foreign currency forward contracts and interest rate cap agreements. The Company does not hold or issue derivative financial instruments for trading purposes.

Effective October 1, 1998, the Company adopted Statement of Financial Accounting Standards No. 133 - "Accounting for Derivative Instruments and Hedging Activities" ("SFAS 133"). SFAS 133 requires the Company to recognize all derivatives on the balance sheet at fair value. Derivatives that are not hedges must be adjusted to fair value through income. If the derivative is a hedge, depending on the nature of the hedge, changes in the fair value of derivatives are either offset against the change in fair value of assets, liabilities, or firm commitments through earnings or recognized in other comprehensive income until the hedged item is recognized in earnings. The ineffective portion of a derivative's change in fair value is immediately recognized in earnings. The adoption of SFAS 133 on October 1, 1998 did not have a material impact on results of operations but resulted in the cumulative effect of an accounting change of $2 million pre-tax being recognized as income in other comprehensive income.

*Notional Amounts and Credit Exposure of Derivatives*

The notional amounts of derivative financial instruments summarized below do not represent amounts exchanged between parties and, therefore, are not a measure of the Company's exposure resulting from its use of derivatives. The amounts exchanged are calculated based upon the notional amounts as well as other terms of the instruments, which relate to interest rates, exchange rates or other indices.

The Company is exposed to credit losses in the event of non-performance by counterparties to these financial instruments, but it does not expect any of the counterparties to fail to meet their obligations. To manage credit risks, the Company selects counterparties based on credit ratings, limits its exposure to a single counterparty under defined Company guidelines, and monitors the market position with each counterparty.

*Fuel Price Risk Management*

The Company uses a combination of petroleum call options, petroleum swap contracts, and jet fuel purchase commitments to provide some short-term protection against a sharp increase in jet fuel prices. These instruments generally cover the Company's forecasted jet fuel needs for three to six months.

The Company accounts for the call options and swap contracts as cash flow hedges. In accordance with SFAS 133, such financial instruments are marked-to-market with the offset to other comprehensive income and then subsequently recognized as a component of fuel expense when the underlying fuel being hedged is used. The ineffective portion of these call and swap agreements is determined based on the correlation between West Texas Intermediate Crude Oil prices and jet fuel prices which was not material for the quarter ended December 31, 1998.

At December 31, 1998, the Company had petroleum swap contracts outstanding with an aggregate notional amount of approximately $82 million and a fair value of approximately $6 million (loss), which has been recorded in other current liabilities with the offset to other comprehensive income, net of applicable income taxes. The loss will be recognized in earnings within the next six months. The Company recognized gains of approximately $65 million under this risk reduction strategy in 1996. Such gains were classified as a reduction in aircraft fuel expense in the accompanying consolidated statements of operations.

Additionally, as of December 31, 1998, the Company had entered into jet fuel purchase commitments of approximately $53 million that relate to jet fuel to be delivered and used during the first quarter of 1999.

*Foreign Currency Exchange Risk Management*

The Company uses a combination of foreign currency average rate option and forward contracts to hedge against the currency risk associated with Japanese yen-denominated ticket sales for the next nine to twelve months. The average rate option and forward contracts have only nominal intrinsic value at the time of purchase.

The Company accounts for these instruments as cash flow hedges. In accordance with SFAS 133, such financial instruments are marked-to-market with the offset to other comprehensive income and then subsequently recognized as a component of passenger revenue when the underlying sales transaction is recognized as revenue. The Company measures hedge effectiveness of average rate options and forward contracts based on the forward price of the underlying commodity. Hedge ineffectiveness was not material during the quarter ended December 31, 1998.

At December 31, 1998, the Company had average rate option and forward contracts outstanding with an aggregate notional amount of approximately $78 million and $76 million, respectively. The fair value of these instruments was $3 million (loss) as of December 31, 1998 which has been recorded in other current liabilities with the offset to other comprehensive income, net of applicable income taxes. The loss will be recognized in earnings within the next twelve months.

*Interest Rate Risk Management*

The Company entered into an interest rate cap agreement to reduce the impact of potential increases on floating rate debt. The interest rate cap has a notional amount of $125 million as of December 31, 1998 and is effective through July 31, 2001. The Company accounts for the interest rate cap as a cash flow hedge whereby the fair value of the interest rate cap is reflected as an asset in the accompanying consolidated balance sheet with the offset, net of any hedge ineffectiveness (which is not material) recorded as interest expense, to other comprehensive income. The fair value of the interest rate cap was not material as of December 31, 1998. As interest expense on the underlying hedged debt is recognized, corresponding amounts are removed from other comprehensive income and charged to interest expense. Such amounts were not material during 1998.

*Accumulated Derivative Gains or Losses*

The following table summarizes activity in other comprehensive income related to derivatives classified as cash flow hedges held by the Company during the period October 1 (the date of the Company's adoption of SFAS 133) through December 31, 1998 (in millions):

| | |
|---|---|
| Cumulative effect of adopting SFAS 133 as of October 1, 1998, net | $ 1 |
| (Gains)/losses reclassified into earnings from other comprehensive income, net | — |
| Change in fair value of derivatives, net | (7) |
| Accumulated derivative loss included in other comprehensive income as of December 31, 1998, net | $ (6) |

*Fair Value of Other Financial Instruments*

(A) CASH EQUIVALENTS —

Cash equivalents consist primarily of commercial paper with original maturities of three months or less and approximate fair value due to their short maturity.

(B) INVESTMENT IN EQUITY SECURITIES —

Continental's investment in America West Holdings Corporation ("America West Holdings") is classified as available-for-sale and carried at an aggregate market value of $3 million and $9 million at December 31, 1998 and 1997, respectively. Included in stockholders' equity at December 31, 1998 and 1997 are net unrealized gains of $1 million and $4 million, respectively.

In June 1998, the Company sold its remaining 317,140 shares of its America West Holdings Class B common stock realizing net proceeds of approximately $8.9 million and recognizing a gain of $6 million. The gain is included in Other, net in the accompanying Consolidated Statements of Operations.

In February 1996, Continental sold approximately 1.4 million of the 1.8 million shares it owned in America West Holdings, realizing net proceeds of $25 million and recognizing a gain of $13 million. In May 1996, the Company sold all of its 802,860 America West Holdings warrants, realizing net proceeds of $7 million and recognizing a gain of $5 million. The gains are included in Other, net in the accompanying Consolidated Statements of Operations.

In May 1998, the Company acquired a 49% interest in Compania Panamena de Aviacion, S.A. ("COPA") for $53 million. The investment is accounted for under the equity method of accounting. As of December 31, 1998, the excess of the amount at which the investment is carried and the amount of underlying equity in the net assets was $43 million. This difference is being amortized over the investment's estimated useful life of 40 years.

As of December 31, 1998, Continental had a 12.4% interest in AMADEUS Global Travel Distribution S.A. ("AMADEUS") with a carrying value of $95 million. Since a readily determinable market value does not exist for the Company's investment in AMADEUS, the investment is carried at cost.

(C) DEBT —

The fair value of the Company's debt with a carrying value of $1.98 billion and $1.49 billion at December 31, 1998 and 1997, respectively, estimated based on the discounted amount of future cash flows using the current incremental rate of borrowing for a similar liability or market prices, approximate $1.88 billion and $1.47 billion, respectively. The fair value of the remaining debt (with a carrying value of $473 million and $179 million, respectively, and primarily relating to aircraft modification notes and various loans with immaterial balances) was not practicable to estimate due to the large number and small dollar amounts of these notes.

(D) PREFERRED SECURITIES OF TRUST —

As of December 31, 1998, the fair value of Continental's 8½% Convertible Trust Originated Preferred Securities ("TOPrS") (with a carrying value of $111 million), estimated based on market prices, approximated $159 million. The carrying value of the TOPrS was $242 million and the fair value approximated $514 as of December 31, 1997. See Note 6.

## Note 6 — Preferred Securities Of Trust

Continental Airlines Finance Trust, a Delaware statutory business trust (the "Trust") with respect to which the Company owned all of the common trust securities, had 2,298,327 and 4,986,500 TOPrS outstanding at December 31, 1998 and 1997, respectively. In November 1998, the Company exercised its right and called for redemption approximately half of its outstanding TOPrS. The TOPrS were convertible into shares of Class B common stock at a conversion price of $24.18 per share of Class B common stock. As a result of the call for redemption, 2,688,173 TOPrS were converted into 5,558,649 shares of Class B common stock. In December 1998, the Company called for redemption the remaining outstanding TOPrS. As a result of the second call, the remaining 2,298,327 TOPrS were converted into 4,752,522 shares of Class B common stock during January 1999.

Distributions on the preferred securities were payable by the Trust at the annual rate of 8½% of the liquidation value of $50 per preferred security and are included in Distributions on Preferred Securities of Trust in the accompanying Consolidated Statements of Operations. At December 31, 1998, outstanding TOPrS totaling $111 million are included in Continental-Obligated Mandatorily Redeemable Preferred Securities of Subsidiary Trust Holding Solely Convertible Subordinated Debentures in the accompanying Consolidated Balance Sheets.

The sole assets of the trust were 8-1/2% Convertible Subordinated Deferrable Interest Debentures ("Convertible Subordinated Debentures") with an aggregate principal amount of $115 million at December 31, 1998.

The Convertible Subordinated Debentures and related income statement effects are eliminated in the Company's consolidated financial statements.

## Note 7 — Redeemable Preferred, Preferred, Treasury and Common Stock

### Redeemable Preferred and Preferred Stock

During the year ended December 31, 1997, the Company's board of directors declared and issued 13,165 additional shares of Series A 12% Cumulative Preferred Stock ("Series A 12% Preferred") in lieu of cash dividends. In April 1997, Continental redeemed for cash all of the 460,247 shares of its Series A 12% Preferred then outstanding for $100 per share plus accrued dividends thereon. The redemption price, including accrued dividends, totaled $48 million.

Continental has 10 million shares of authorized preferred stock, none of which was outstanding as of December 31, 1998 or 1997.

### Common Stock

Continental has two classes of common stock issued and outstanding, Class A common stock, par value $.01 per share ("Class A common stock"), and Class B common stock. Holders of shares of Class A common stock and Class B common stock are entitled to receive dividends when and if declared by the Company's board of directors. Each share of Class A common stock is entitled to 10 votes per share and each share of Class B common stock is entitled to one vote per share. In addition, Continental has authorized 50 million shares of Class D common stock, par value $.01 per share, none of which is outstanding.

The Company's Certificate of Incorporation permits shares of the Company's Class A common stock to be converted into an equal number of shares of Class B common stock. During 1998 and 1997, 12,200 and 900,536 shares of the Company's Class A common stock, respectively, were so converted.

### Treasury Stock

During 1998, the Company's Board of Directors authorized the expenditure of up to $300 million to repurchase shares of the Company's Class A and Class B common stock or securities convertible into Class B common stock. No time limit was placed on the duration of the repurchase program. Subject to applicable securities law, such purchases occur at times and in amounts that the Company deems appropriate. As of December 31, 1998, the Company had repurchased 4,452,700 shares of Class B common stock for $223 million.

### Stockholder Rights Plan

Effective November 20, 1998, the Company adopted a stockholder rights plan (the "Rights Plan") in connection with the disposition by Air Partners, L.P. ("Air Partners") of its interest in the Company to an affiliate of Northwest Airlines, Inc. (together with such affiliate, "Northwest").

The rights become exercisable upon the earlier of (i) the tenth day following a public announcement or public disclosure of facts indicating that a person or group of affiliated or associated persons has acquired beneficial ownership of 15% or more of the total number of votes entitled to be cast generally by the holders of the common stock of the Company then outstanding, voting together as a single class (such person or group being an "Acquiring Person"), or (ii) the tenth business day (or such later date as may be determined by action of the Board of Directors prior to such time as any person becomes an Acquiring Person) following the commencement of, or announcement of an intention to make, a tender offer or exchange offer the consummation of which would result in any person becoming an Acquiring Person. Certain persons and entities related to the Company, Air Partners or Northwest at the time the Rights Plan was adopted are exempt from the definition of "Acquiring Person."

The rights will expire on November 20, 2008 unless extended or unless the rights are earlier redeemed or exchanged by the Company.

Subject to certain adjustments, if any person becomes an Acquiring Person, each holder of a right, other than rights beneficially owned by the Acquiring Person and its affiliates and associates (which rights will thereafter be void), will thereafter have the right to receive, upon exercise thereof, that number of Class B Common Shares having a market value of two times the exercise price ($200, subject to adjustment) of the right.

If at any time after a person becomes an Acquiring Person, (i) the Company merges into any other person, (ii) any person merges into the Company and all of the outstanding common stock does not remain outstanding after such merger, or (iii) the Company sells 50% or more of its consolidated assets or earning power, each holder of a right (other than the Acquiring Person and its affiliates and associates) will have the right to receive, upon the exercise thereof, that number of shares of common stock of the acquiring corporation (including the Company as successor thereto or as the surviving corporation) which at the time of such transaction will have a market value of two times the exercise price of the right.

At any time after any person becomes an Acquiring Person, and prior to the acquisition by any person or group of a majority of the Company's voting power, the Board of Directors may exchange the rights (other than rights owned by such Acquiring Person which have become void), in whole or in part, at an exchange ratio of one share of Class B common stock per right (subject to adjustment).

At any time prior to any person becoming an Acquiring Person, the Board of Directors may redeem the rights at a price of $.001 per right. The Rights Plan may be amended by the Board of Directors without the consent of the holders of the rights, except that from and after such time as any person becomes an Acquiring Person no such amendment may adversely affect the interests of the holders of the rights (other than the Acquiring Person and its affiliates and associates). Until a right is exercised, the holder thereof, as such, will have no rights as a stockholder of the Company, including, without limitation, the right to vote or to receive dividends.

### Warrants

As of December 31, 1997, the Company had outstanding 3,039,468 Class A Warrants and 308,343 Class B Warrants. The warrants entitled the holder to purchase one share of Class A common stock or Class B common stock as follows: (i) 2,298,134 Class A Warrants and 186,134 Class B Warrants with an exercise price $7.50 per share, and (ii) 741,334 Class A Warrants and 122,209 Class B Warrants with an exercise price of $15.00 per share. During 1998, all remaining Class A and Class B Warrants outstanding were exercised.

On June 2, 1997, the Company purchased from Air Partners warrants to purchase 3,842,542 shares of Class B common stock for $94 million, the intrinsic value of the warrants (the difference between the closing market price of the Class B common stock on May 28, 1997 ($34.25) and the applicable exercise price).

On November 21, 1996, Air Partners exercised its right to sell to the Company, and the Company subsequently purchased, for $50 million, Warrants to purchase 2,614,379 shares of Class B common stock pursuant to an agreement with the Company entered into earlier in 1996.

## Note 8 — Stock Plans And Awards

### Stock Options

On May 21, 1998, the stockholders of the Company approved the Continental Airlines, Inc. 1998 Stock Incentive Plan (the "98 Incentive Plan") under which the Company may issue shares of restricted Class B common stock or grant options to purchase shares of Class B common stock to non-employee directors and employees of the Company or its subsidiaries. Subject to adjustment as provided in the 98 Incentive Plan, the aggregate number of shares of Class B common stock that may be issued under the 98 Incentive Plan may not exceed 5,500,000 shares, which may be originally issued or treasury shares or a combination thereof. The maximum number of shares of Class B common stock that may be subject to options granted to any one individual during any calendar year may not exceed 750,000 shares. In early December 1998, the Company offered certain employees who were granted options during the period from May 21, 1998 to November 20, 1998 (excluding the Company's executive officers, certain other officers and members of its Board) the opportunity to exchange such options for a lesser number of new options bearing an exercise price equal to the closing price of the Class B common stock on the date of grant, which was lower than that of the exchanged options. Employees who exchanged their options forfeited the vesting on their old options and received 65 new options for every 100 old options exchanged. As a result, 1,874,000 old options were exchanged for 1,218,100 new options. The new options are subject to a new four-year vesting schedule commencing on the date of grant. The exchange did not result in recognition of compensation expense. The total shares remaining available for grant under the 98 Incentive Plan at December 31, 1998 was 990,000. Stock options granted under the 98 Incentive Plan generally vest over a period of four years and have a term of five years.

On May 16, 1997, the stockholders of the Company approved the Continental Airlines, Inc. 1997 Stock Incentive Plan, as amended (the "97 Incentive Plan"), under which the Company may award restricted stock or grant options to purchase shares of Class B common stock to non-employee directors of the Company and employees of the Company or its subsidiaries. Subject to adjustment as provided in the 97 Incentive Plan, the aggregate number of shares of Class B common stock that may be issued under the 97 Incentive Plan may not exceed 2,000,000 shares, which may be originally issued or treasury shares or a combination thereof. The maximum number of shares of Class B common stock that may be subject to options granted to any one individual during any calendar year may not exceed 200,000 shares (subject to adjustment as provided in the 97 Incentive Plan). The total shares remaining available for grant under the 97 Incentive Plan at December 31, 1998 was 563,988. Stock options granted under the 97 Incentive Plan generally vest over a period of three years and have a term of five years.

Under the Continental Airlines, Inc. 1994 Incentive Equity Plan, as amended (the "94 Incentive Plan" and, together with the 97 Incentive Plan and the 98 Incentive Plan, the "Incentive Plans"), key officers and employees of the Company and its subsidiaries received stock options and/or restricted stock. The 94 Incentive Plan also provided for each outside director to receive on the day following the annual stockholders' meeting options to purchase 5,000 shares of Class B common stock. The maximum number of shares of Class B common stock that may be issued under the 94 Incentive Plan may not in the aggregate exceed 9,000,000. The total remaining shares available for grant under the 94 Incentive Plan at December 31, 1998 was 201,754.

Under the terms of the Incentive Plans, a change of control would result in all outstanding options under these plans becoming exercisable in full and restrictions on restricted shares being terminated. On November 20, 1998, Air Partners disposed of its interest in the Company to Northwest, resulting in a change of control under the terms of the 97 Incentive Plan and the 94 Incentive Plan. As a result, all outstanding options and restricted stock under these plans became exercisable and fully vested, respectively.

The following table summarizes stock option transactions pursuant to the Company's Incentive Plans (share data in thousands):

| | 1998 | | 1997 | | 1996 | |
|---|---|---|---|---|---|---|
| | Options | Weighted-Average Exercise Price | Options | Weighted-Average Exercise Price | Options | Weighted-Average Exercise Price |
| Outstanding at Beginning of Year | 5,998 | $22.62 | 5,809 | $17.37 | 4,769 | $ 8.41 |
| Granted* | 6,504 | $43.75 | 1,968 | $29.34 | 3,307 | $25.07 |
| Exercised | (807) | $19.53 | (1,582) | $11.72 | (1,747) | $ 8.23 |
| Cancelled | (2,012) | $55.18 | (197) | $22.49 | (520) | $14.83 |
| Outstanding at End of Year | 9,683 | $30.31 | 5,998 | $22.62 | 5,809 | $17.37 |
| Options exercisable at end of year | 5,174 | $23.56 | 1,229 | $20.61 | 656 | $11.18 |

*The option price for all stock options is equal to 100% of the fair market value at the date of grant.

The following tables summarize the range of exercise prices and the weighted average remaining contractual life of the options outstanding and the range of exercise prices for the options exercisable at December 31, 1998 (share data in thousands):

| Options Outstanding | | | |
|---|---|---|---|
| Range of Exercise Prices | Outstanding | Weighted Average Remaining Contractual Life | Weighted Average Exercise Price |
| $3.88-$8.00 | 915 | 2.25 | $7.46 |
| $8.19-$28.19 | 1,881 | 2.44 | $22.68 |
| $28.25-$34.75 | 3,443 | 3.75 | $29.23 |
| $34.88-$35.00 | 2,306 | 4.90 | $35.00 |
| $35.31-$56.81 | 1,138 | 4.62 | $55.05 |
| $3.88-$56.81 | 9,683 | 3.73 | $30.31 |

| Options Exercisable | | |
|---|---|---|
| Range of Exercise Prices | Exercisable | Weighted Average Exercise Price |
| $3.88-$8.00 | 915 | $ 7.46 |
| $8.19-$28.19 | 1,881 | $22.68 |
| $28.25-$34.75 | 2,222 | $29.25 |
| $34.88-$35.00 | 2 | $35.00 |
| $35.31-$56.81 | 154 | $47.72 |
| $3.88-$56.81 | 5,174 | $23.56 |

### Restricted Stock

The Incentive Plans permit awards of restricted stock to participants, subject to one or more restrictions, including a restriction period, and a purchase price, if any, to be paid by the participant. Under the 98 Incentive Plan, the 97 Incentive Plan and the 94 Incentive Plan, 250,000, 100,000 and 600,000 shares, respectively, have been authorized for issuance, of which 250,000, 100,000 and 35,000 shares were available for grant at December 31, 1998.

Additionally, on March 4, 1994, the Board approved a one-time grant of 2,014,000 shares of restricted Class B common stock to substantially all employees at or below the manager level. These shares were issued at no cost to the employees and vested in 25 percent increments on each of January 2, 1995, 1996, 1997 and 1998.

### Employee Stock Purchase Plans

On May 16, 1997, the stockholders of the Company approved the Continental Airlines, Inc. 1997 Employee Stock Purchase Plan (the "97 Stock Purchase Plan"). Under the 97 Stock Purchase Plan, all employees of the Company may purchase shares of Class B common stock of the Company at 85% of the lower of the fair market value on the first day of the option period or the last day of the option period. Subject to adjustment, a maximum of 1,750,000 shares of Class B common stock are authorized for issuance under the 97 Stock Purchase Plan. In January 1999, 132,928 shares of Class B common stock were issued for $28.47 per share relating to contributions made in fourth quarter of 1998. During 1998 and 1997, 305,978 and 148,186 shares of Class B common stock were issued at prices ranging from $29.33 to $49.41 in 1998 and $23.38 to $29.33 in 1997.

Under the Continental Airlines, Inc. 1994 Employee Stock Purchase Plan, as amended (the "94 Stock Purchase Plan"), which terminated on December 31, 1996, substantially all employees of the Company could purchase shares of Class B common stock at 85% of the lower of the fair market value on the first or last business day of a calendar quarter. Subject to adjustment, a maximum of 8,000,000 shares of Class B common stock were authorized for purchase under the 94 Stock Purchase Plan. During 1997, 1996 and 1995, 70,706, 191,809 and 518,428 shares, respectively, of Class B common stock were issued at a price of $19.55 in 1997 and at prices ranging from $15.81 to $23.96 in 1996 and $4.31 to $10.63 in 1995 in connection with the 94 Stock Purchase Plan.

### Pro Forma SFAS 123 Results

Pro forma information regarding net income and earnings per share has been determined as if the Company had accounted for its employee stock options and purchase rights under the fair value method of SFAS 123. The fair value for these options was estimated at the date of grant using a Black-Scholes option pricing model with the following weighted-average assumptions for 1998, 1997 and 1996, respectively: risk-free interest rates of 4.9%, 6.1% and 5.8%; dividend yields of 0%; volatility factors of the expected market price of the Company's common stock of 40% for 1998, 34% for 1997 and 39% for

1996; and a weighted-average expected life of the option of 3.0 years, 2.5 years and 2.6 years. The weighted average grant date fair value of the stock options granted in 1998, 1997 and 1996 was $13.84, $7.87 and $7.55 per option, respectively.

The fair value of the purchase rights under the Stock Purchase Plans was also estimated using the Black-Scholes model with the following weighted-average assumptions for 1998, 1997 and 1996, respectively: risk free interest rates of 4.7%, 5.2% and 5.2%; dividend yields of 0%; expected volatility of 40% for 1998, 34% for 1997 and 39% for 1996; and an expected life of .25 years for 1998, .33 years for 1997 and .25 years for 1996. The weighted-average fair value of the purchase rights granted in 1998, 1997 and 1996 was $9.10, $7.38 and $5.75, respectively.

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options which have no vesting restrictions and are fully transferrable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. Because the Company's employee stock options and purchase rights have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options and purchase rights.

Assuming that the Company had accounted for its employee stock options and purchase rights using the fair value method and amortized the resulting amount to expense over the options' vesting period net income would have been reduced by $18 million, $11 million and $9 million for the years ended December 31, 1998, 1997 and 1996, respectively. Basic EPS would have been reduced by 30 cents, 18 cents and 17 cents for the years ended December 31, 1998, 1997 and 1996, respectively, and diluted EPS would have been reduced by 23 cents, 14 cents and 11 cents for the same periods, respectively. The pro forma effect on net income is not representative of the pro forma effects on net income in future years because it did not take into consideration pro forma compensation expense related to grants made prior to 1995.

## Note 9 — Accumulated Other Comprehensive Income

The components of accumulated other comprehensive income are as follows (in millions):

| | Minimum Pension Liability | Unrealized Gain/(Loss) on Investments | Loss on Derivative Instruments | Total |
|---|---|---|---|---|
| Balance at December 31, 1995 | $ (8) | $ 18 | $ — | $ 10 |
| Current year change in other comprehensive income | 6 | (14) | — | (8) |
| Balance at December 31, 1996 | (2) | 4 | — | 2 |
| Current year change in other comprehensive income | (4) | — | — | (4) |
| Balance at December 31, 1997 | (6) | 4 | — | (2) |
| Current year change in other comprehensive income | (76) | (4) | (6) | (86) |
| Balance at December 31, 1998 | $ (82) | $ — | $ (6) | $ (88) |

## Note 10 — Employee Benefit Plans

The Company has noncontributory defined benefit pension and defined contribution (including 401(k) savings) plans. Substantially all domestic employees of the Company are covered by one or more of these plans. The benefits under the active defined benefit pension plan are based on years of service and an employee's final average compensation. For the years ended December 31, 1998, 1997 and 1996, total expense for the defined contribution plan was $8 million, $6 million and $7 million, respectively.

The following table sets forth the defined benefit pension plans' change in projected benefit obligation for 1998 and 1997:

| | 1998 | 1997 |
|---|---|---|
| | (in millions) | |
| Projected benefit obligation at beginning of year | $ 846 | $ 604 |
| Service cost | 55 | 38 |
| Interest cost | 69 | 51 |
| Plan amendments | 110 | — |
| Actuarial gains, net | 178 | 176 |
| Benefits paid | (28) | (23) |
| Projected benefit obligation at end of year | $1,230 | $ 846 |

The following table sets forth the defined benefit pension plans' change in the fair value of plan assets for 1998 and 1997:

| | 1998 | 1997 |
|---|---|---|
| | (in millions) | |
| Fair value of plan assets at beginning of year | $ 633 | $ 508 |
| Actual return on plan assets | 75 | 83 |
| Employer contributions | 101 | 65 |
| Benefits paid | (28) | (23) |
| Fair value of plan assets at end of year | $ 781 | $ 633 |

Pension cost recognized in the accompanying Consolidated Balance Sheets is computed as follows:

| | 1998 | 1997 |
|---|---|---|
| | (in millions) | |
| Funded status of the plans — net underfunded | $ (449) | $ (213) |
| Unrecognized net actuarial loss | 256 | 93 |
| Unrecognized prior service cost | 113 | 9 |
| Net amount recognized | (80) | (111) |
| Prepaid benefit cost | 2 | 16 |
| Accrued benefit liability | (320) | (136) |
| Intangible asset | 113 | — |
| Accumulated other comprehensive income | 125 | 9 |
| Net amount recognized | $ (80) | $ (111) |

Net periodic defined benefit pension cost for 1998, 1997 and 1996 included the following components:

| | 1998 | 1997 | 1996 |
|---|---|---|---|
| | | (in millions) | |
| Service cost | $ 55 | $ 38 | $ 38 |
| Interest cost | 69 | 51 | 45 |
| Expected return on plan assets | (64) | (49) | (38) |
| Amortization of prior service cost | 6 | 1 | 1 |
| Amortization of unrecognized net actuarial loss | 4 | — | — |
| Settlement gain | — | — | (1) |
| Net periodic benefit cost | $ 70 | $ 41 | $ 45 |

The projected benefit obligation, accumulated benefit obligation and the fair value of plan assets for the pension plans with projected benefit obligations and accumulated benefit obligations in excess of plan assets were $1.2 billion, $1.1 billion and $771 million, respectively, as of December 31, 1998, and $762 million, $620 million and $529 million, respectively, as of December 31, 1997.

During 1998, the Company amended its benefit plan as a result of changes in benefits pursuant to new collective bargaining agreements.

Plan assets consist primarily of equity securities (including 32,500 and 50,000 shares of Class B common stock with a fair market value of $1.1 million and $2.4 million as of December 31, 1998 and 1997, respectively), long-term debt securities and short-term investments.

The weighted average discount rate used in determining the actuarial present value of the projected benefit obligation was 7.00% to 7.25%, 7.25% and 7.75% for 1998, 1997 and 1996, respectively. The expected long-term rate of return on assets (which is used to calculate the Company's return on pension assets for the current year) was 9.25% to 9.50% for 1998, and 9.25% for each of 1997 and 1996. The weighted average rate of salary increases was 5.30% for 1998, and 4.90% for each of 1997 and 1996. The 1983 Group Annuity Mortality Table (GAM 83) was used to develop the 1997 and 1998 end-of-year disclosure amounts and 1998 pension cost. The 1984 Unisex Pensioners Mortality Table (UP 84) was used to develop 1996 end-of-year disclosure and 1996 and 1997 pension cost. The unrecognized net gain (loss) is amortized on a straight-line basis over the average remaining service period of employees expected to receive a plan benefit.

Continental's policy is to fund the noncontributory defined benefit pension plans in accordance with Internal Revenue Service ("IRS") requirements as modified, to the extent applicable, by agreements with the IRS.

The Company also has a profit sharing program under which an award pool consisting of 15.0% of the Company's annual pre-tax earnings, subject to certain adjustments, is distributed each year to substantially all employees (other than employees whose collective bargaining agreement provides otherwise or who otherwise receive profit sharing payments as required by local law) on a pro rata basis according to base salary. The profit sharing expense included in the accompanying Consolidated Statements of Operations for the years ended December 31, 1998, 1997 and 1996 was $86 million, $105 million and $68 million, respectively.

## Note 11 — Income Taxes

The reconciliations of income tax computed at the United States federal statutory tax rates to income tax provision for the years ended December 31, 1998, 1997 and 1996 are as follows (in millions):

| | Amount | | | Percent | | |
|---|---|---|---|---|---|---|
| | 1998 | 1997 | 1996 | 1998 | 1997 | 1996 |
| Income tax provision at United States statutory rates | $ 227 | $224 | $150 | 35.0% | 35.0% | 35.0% |
| State income tax provision | 10 | 9 | 6 | 1.5 | 1.4 | 1.4 |
| Reorganization value in excess of amounts allocable to identifiable assets | — | 4 | 5 | — | 0.6 | 1.2 |
| Meals and entertainment disallowance | 10 | 9 | 7 | 1.5 | 1.4 | 1.6 |
| Net operating loss not previously benefitted | — | (15) | (88) | — | (2.3) | (20.5) |
| Other | 1 | 6 | 6 | 0.3 | 1.0 | 1.4 |
| Income tax provision, net | $ 248 | $237 | $ 86 | 38.3% | 37.1% | 20.1% |

The significant component of the provision for income taxes for the year ended December 31, 1998, 1997 and 1996 was a deferred tax provision of $231 million, $220 million and $80 million, respectively. The provision for income taxes for the period ended December 31, 1998, 1997 and 1996 also reflects a current tax provision in the amount of $17 million, $17 million and $6 million, respectively, as the Company is in an alternative minimum tax position for federal income tax purposes and pays current state income tax.

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the related amounts used for income tax purposes. Significant components of the Company's deferred tax liabilities and assets as of December 31, 1998 and 1997 are as follows (in millions):

| | 1998 | 1997 |
|---|---|---|
| Spare parts and supplies, fixed assets and intangibles | $ 536 | $ 639 |
| Deferred gain | 57 | 63 |
| Capital and safe harbor lease activity | 46 | 49 |
| Other, net | 39 | 39 |
| Gross deferred tax liabilities | 678 | 790 |
| Accrued liabilities | (347) | (370) |
| Revaluation of leases | (2) | (16) |
| Net operating loss carryforwards | (372) | (631) |
| Investment tax credit carryforwards | (45) | (45) |
| Minimum tax credit carryforward | (37) | (21) |
| Gross deferred tax assets | (803) | (1,083) |
| Deferred tax assets valuation allowance | 263 | 617 |
| Net deferred tax liability | 138 | 324 |
| Less: current deferred tax (asset) liability | (234) | (111) |
| Non-current deferred tax liability | $ 372 | $ 435 |

At December 31, 1998, the Company had estimated NOLs of $1.1 billion for federal income tax purposes that will expire through 2009 and federal investment tax credit carryforwards of $45 million that will expire through 2001. As a result of the change in ownership of the Company on April 27, 1993, the ultimate utilization of the Company's net operating losses and investment tax credits could be limited. Reflecting this possible limitation, the Company has recorded a valuation allowance of $263 million at December 31, 1998.

Continental had, as of December 31, 1998, deferred tax assets aggregating $803 million, including $372 million of NOLs and a valuation allowance of $263 million. During the first quarter of 1998, the Company consummated several transactions, the benefit of which resulted in the elimination of reorganization value in excess of amounts allocable to identifiable assets of $164 million. During the third and fourth quarters of 1998, the Company determined that additional NOLs of the Company's predecessor could be benefited and accordingly reduced both the valuation allowance and routes, gates and slots by $190 million. To the extent the Company were to determine in the future that additional NOLs of the Company's predecessor could be recognized in the accompanying consolidated financial statements, such benefit would further reduce routes, gates and slots.

## Note 12 — Accruals for Aircraft Retirements and Excess Facilities

In August 1998, the Company announced that CMI plans to accelerate the retirement of its four Boeing 747 aircraft by April 1999 and its remaining thirteen Boeing 727 aircraft by December 2000. The Boeing 747s will be replaced by DC-10-30 aircraft and the Boeing 727 aircraft will be replaced with a reduced number of Boeing 737 aircraft. In addition, Express will accelerate the retirement of certain turboprop aircraft by December 2000, including its fleet of 32 EMB-120 turboprop aircraft, as regional jets are acquired to replace turboprops.

In connection with its decision to accelerate the replacement of these aircraft, the Company performed an evaluation to determine, in accordance with SFAS 121, whether future cash flows (undiscounted and without interest charges) expected to result from the use and eventual disposition of these aircraft would be less than the aggregate carrying amount of these aircraft and the related assets. As a result of the evaluation, management determined that the estimated future cash flows expected to be generated by these aircraft would be less than their carrying amount, and therefore these aircraft are impaired as defined by SFAS 121. Consequently, the original cost basis of these aircraft and related items was reduced to reflect the fair market value at the date the decision was made, resulting in a $59 million fleet disposition/impairment loss. In determining the fair market value of these assets, the Company considered recent transactions involving sales of similar aircraft and market trends in aircraft dispositions. The remaining $63 million of the fleet disposition/impairment loss includes cash and non-cash costs related primarily to future commitments on leased aircraft past the dates they will be removed from service and the write-down of related inventory to its estimated fair market value. The combined charge of $122 million was recorded in the third quarter of 1998.

During 1996, the Company made the decision to accelerate the replacement of certain aircraft between August 1997 and December 1999. As a result of its decision to accelerate the replacement of these aircraft, the Company recorded a fleet disposition charge of $128 million. The fleet disposition charge related primarily to (i) the writedown of Stage 2 aircraft inventory, which is not expected to be consumed through operations, to its estimated fair value; and (ii) a provision for costs associated with the return of leased aircraft at the end of their respective lease terms. The majority of the aircraft are being accounted for as operating leases and therefore the Company will continue to recognize rent and amortization expenses on these aircraft until they are removed from service.

During 1994, the Company recorded a $447 million provision associated with (i) the planned early retirement of certain aircraft ($278 million) and (ii) closed or underutilized airport and maintenance facilities and other assets ($169 million).

The following represents the activity within these accruals during the three years ended December 31, 1998 (in millions):

| | 1998 | 1997 | 1996 |
|---|---|---|---|
| Total accruals at beginning of year | $151 | $205 | $220 |
| Net cash payments: | | | |
| Aircraft related | (34) | (27) | (52) |
| Underutilized facilities and other | (30) | (13) | (17) |
| Increase/(decrease) in accrual for grounded aircraft | — | (16) | — |
| Fleet disposition charge for cost of return of leased aircraft | — | — | 54 |
| Fleet disposition/impairment loss for the retirement of aircraft | 63 | — | — |
| Other | 5 | 2 | — |
| Total accruals at end of year | 155 | 151 | 205 |
| Portion included in accrued other liabilities | (60) | (28) | (17) |
| Accrual for aircraft retirements and excess facilities | $ 95 | $123 | $188 |

The remaining accruals relate primarily to anticipated cash outlays associated with (i) underutilized airport facilities (primarily associated with Denver International Airport), (ii) the return of leased aircraft and (iii) the remaining liability associated with the grounded aircraft. The Company has assumed certain sublease rental income for these closed and underutilized facilities and grounded aircraft in determining the accrual at each balance sheet date. However, should actual sublease rental income be different from the Company's estimates, the actual charge could be different from the amount estimated. The remaining accrual represents cash outlays to be incurred over the remaining lease terms (from one to 12 years).

## Note 13 — Commitments and Contingencies

Continental has substantial commitments for capital expenditures, including for the acquisition of new aircraft. As of January 20, 1999, Continental had agreed to acquire a total of 113 Boeing jet aircraft through 2005, approximately 57 of which are expected to be delivered in 1999. Continental also has options for an additional 114 aircraft (exercisable subject to certain conditions). The estimated aggregate cost of the Company's firm commitments for Boeing aircraft is approximately $5.5 billion. Continental currently plans to finance its new Boeing aircraft with a combination of enhanced pass through trust certificates, lease equity and other third-party financing, subject to availability and market conditions. As of January 20, 1999, Continental had approximately $354 million in financing arranged for such future Boeing deliveries. In addition, Continental had commitments or letters of intent for backstop financing for approximately one-third of the anticipated remaining acquisition cost of such Boeing deliveries. In addition, at January 20, 1999, Continental has firm commitments to purchase 32 spare engines related to the new Boeing aircraft for approximately $167 million, which will be deliverable through December 2004. However, further financing will be needed to satisfy the Company's capital commitments for other aircraft and aircraft-related expenditures such as engines, spare parts, simulators and related items. There can be no assurance that sufficient financing will be available for all aircraft and other capital expenditures not covered by firm financing commitments. Deliveries of new Boeing aircraft are expected to increase aircraft rental, depreciation and interest costs while generating cost savings in the areas of maintenance, fuel and pilot training.

As of January 20, 1999, Express had firm commitments for 38 Embraer ERJ-145 ("ERJ-145") 50-seat regional jets and 25 Embraer ERJ-135 ("ERJ-135") 37-seat regional jets, with options for an additional 125 ERJ-145 and 50 ERJ-135 aircraft exercisable through 2008. Express anticipates taking delivery of 19 ERJ-145 and six ERJ-135 regional jets in 1999. Neither Express nor Continental will have any obligation to take any ERJ-145 firm aircraft that are not financed by a third party and leased to Continental.

Continental expects its cash outlays for 1999 capital expenditures, exclusive of fleet plan requirements, to aggregate $254 million primarily relating to mainframe, software application and automation infrastructure projects, aircraft modifications and mandatory maintenance projects, passenger terminal facility improvements and office, maintenance, telecommunications and ground equipment.

Continental remains contingently liable until December 1, 2015, on $202 million of long-term lease obligations of US Airways, Inc. ("US Airways") related to the East End Terminal at LaGuardia Airport in New York. If US Airways defaulted on these obligations, Continental could be required to cure the default, at which time it would have the right to reoccupy the terminal.

During 1998, Continental began block space arrangements whereby it is committed to purchase capacity on other carriers at an aggregate cost of approximately $150 million per year. These arrangements are for 10 years. Pursuant to other block-space arrangements, other carriers are committed to purchase capacity at a cost of approximately $100 million on Continental.

Approximately 40% of the Company's employees are covered by collective bargaining agreements. The Company's collective bargaining agreements with its Express flight attendants and Continental Airlines flight attendants (representing approximately 17% of the Company's employees) become amendable in November and December 1999. Negotiations are expected to begin in the third quarter of 1999 to amend these contracts. The Company believes that mutually acceptable agreements can be reached with such employees, although the ultimate outcome of the Company's negotiations is unknown at this time.

**Legal Proceedings**

*United States of America v. Northwest Airlines Corp. & Continental Airlines, Inc.:* The Antitrust Division of the Department of Justice is challenging under Section 7 of the Clayton Act and Section 1 of the Sherman Act the acquisition by Northwest of shares of Continental's Class A common stock bearing, together with certain shares for which Northwest has a limited proxy, more than 50% of the fully diluted voting power of all Continental stock. The government's position is that, notwithstanding various agreements that severely restrict Northwest's ability to exercise voting control over Continental and are designed to assure Continental's competitive independence, Northwest's control of the Class A common stock will reduce actual and potential competition in various ways and in a variety of markets. Continental believes that because of agreements restricting Northwest's right to exercise control over Continental, the companies remain independent competitors; Northwest's stock acquisition was made solely for investment purposes and thus is expressly exempt under Section 7 of the Clayton Act; and Northwest's stock acquisition was necessary in order for Northwest and Continental to enter into an alliance agreement that is highly pro-competitive. The government seeks an order requiring Northwest to divest all voting stock in Continental on terms and conditions as may be agreed to by the government and the Court. No specific relief is sought against Continental.

The Company and/or certain of its subsidiaries are defendants in various lawsuits, including suits relating to certain environmental claims, the Company's consolidated Plan of Reorganization under Chapter 11 of the federal bankruptcy code which became effective on April 27, 1993, the Company's long-term global alliance agreement with Northwest entered into in connection with Air Partners' disposition of its interest in Continental to Northwest (see Note 14) and proceedings arising in the normal course of business. While the outcome of these lawsuits and proceedings cannot be predicted with certainty and could have a material adverse effect on the Company's financial position, results of operations and cash flows, it is the opinion of management, after consulting with counsel, that the ultimate disposition of such suits will not have a material adverse effect on the Company's financial position, results of operations or cash flows.

## Note 14 — Related Party Transactions

The following is a summary of significant related party transactions that occurred during 1998, 1997 and 1996, other than those discussed elsewhere in the Notes to Consolidated Financial Statements.

In connection with certain synergies agreements, Continental paid Air Canada, a former significant stockholder of the Company, $30 million and $16 million for the years ended December 31, 1997 and 1996, respectively, and Air Canada paid Continental $16 million and $17 million in 1997 and 1996, respectively, primarily relating to aircraft maintenance.

The Company and America West Airlines, Inc. ("America West"), a subsidiary of America West Holdings, in which David Bonderman holds a significant interest, entered into a series of agreements during 1994 related to code-sharing and ground handling that have created substantial benefits for both airlines. Mr. Bonderman is a director of the Company and holds a significant interest in the Company. The services provided are considered normal to the daily operations of both airlines. As a result of these agreements, Continental paid America West $15 million, $16 million and $15 million in 1998, 1997 and 1996, respectively, and America West paid Continental $27 million, $23 million and $22 million in 1998, 1997 and 1996, respectively.

In May 1996, Air Canada converted all of its 3,322,112 shares of Class A common stock into Class B common stock (pursuant to certain rights granted to it under the Company's Certificate of Incorporation) and sold, on the open market, 4,400,000 shares of the Company's common stock pursuant to the Secondary Offering.

On November 21, 1996, Air Partners, a significant stockholder of the Company, exercised its right to sell to the Company, and the Company subsequently purchased, for $50 million, warrants to purchase 2,614,379 shares of Class B common stock (representing a portion of the total warrants held by Air Partners) pursuant to an agreement entered into earlier in 1996 with the Company.

In April 1997, Continental redeemed for cash all of the 460,247 outstanding shares of its Series A 12% Preferred held by an affiliate of Air Canada for $100 per share plus accrued dividends thereon. The redemption price, including accrued dividends, totaled $48 million.

On June 2, 1997, the Company purchased for $94 million from Air Partners warrants to purchase 3,842,542 shares of Class B common stock (representing a portion of the total warrants held by Air Partners). The purchase price represented the intrinsic value of the warrants (the difference between the closing market price of the Class B common stock on May 28, 1997 ($34.25) and the applicable exercise price).

In July 1997, the Company purchased the rights of United Micronesia Development Association, Inc. ("UMDA") to receive future payments under a services agreement between UMDA and CMI (pursuant to which CMI was to pay UMDA approximately 1% of the gross revenues of CMI, as defined, through January 1, 2012, which payment by CMI to UMDA totaled $1 million, $6 million and $6 million in 1997, 1996 and 1995, respectively) and UMDA's 9% interest in AMI, terminated the Company's obligations to UMDA under a settlement agreement entered into in 1987, and terminated substantially all of the other contractual arrangements between the Company, AMI and CMI, on the one hand, and UMDA on the other hand, for an aggregate consideration of $73 million.

In connection with the Company's $320 million secured term loan financing, entered into in 1996, CMI paid UMDA a dividend of approximately $13 million in 1996.

In November 1998, the Company and Northwest, a significant stockholder of the Company, began implementing a long-term global alliance involving extensive code-sharing, frequent flyer reciprocity and other cooperative activities.

## Note 15 — Segment Reporting

Continental adopted Statement of Financial Accounting Standards No. 131 – "Disclosure About Segments of an Enterprise and Related Information" ("SFAS 131") during the first quarter of 1998. SFAS 131 established standards for reporting information about operating segments in annual financial statements as well as related disclosures about products and services, geographic areas and major customers. Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker, or decision making group, in deciding how to allocate resources and in assessing performance. Continental has one reportable operating segment (air transportation).

Information concerning principal geographic areas is as follows (in millions):

| | 1998 Operating Revenue | 1997 Operating Revenue | 1996 Operating Revenue |
|---|---|---|---|
| Domestic (U.S.) | $5,620 | $5,215 | $4,761 |
| Atlantic | 995 | 778 | 494 |
| Latin America | 769 | 572 | 406 |
| Pacific | 567 | 648 | 699 |
| | $7,951 | $7,213 | $6,360 |

The Company attributes revenue among the geographical areas based upon the origin and destination of each flight segment. The Company's tangible assets consist primarily of flight equipment which is mobile across geographic markets and, therefore, has not been allocated.

## Note 16 — Quarterly Financial Data (Unaudited)

Unaudited summarized financial data by quarter for 1998 and 1997 is as follows (in millions, except per share data):

| | Three Months Ended | | | |
|---|---|---|---|---|
| | March 31 | June 30 | September 30 | December 31 |
| **1998** | | | | |
| Operating revenue | $1,854 | $2,036 | $2,116 | $1,945 |
| Operating income | 150 | 280 | 143 | 128 |
| Nonoperating income (expense), net | (13) | (5) | (18) | (17) |
| Net income | 81 | 163 | 73 | 66 |
| Earnings per common share: | | | | |
| Income before extraordinary charge | $ 1.38 | $ 2.74 | $ 1.21 | $ 1.08 |
| Extraordinary charge, net of tax | — | (0.06) | — | — |
| Net income (a) | $ 1.38 | $ 2.68 | $ 1.21 | $ 1.08 |
| Earnings per common share assuming dilution: | | | | |
| Income before extraordinary charge | $ 1.06 | $ 2.11 | $ 0.97 | $ 0.91 |
| Extraordinary charge, net of tax | — | (0.05) | — | — |
| Net income (a) | $ 1.06 | $ 2.06 | $ 0.97 | $ 0.91 |
| **1997** | | | | |
| Operating revenue | $1,698 | $1,786 | $1,890 | $1,839 |
| Operating income | 146 | 231 | 207 | 132 |
| Nonoperating income (expense), net | (22) | (23) | (21) | (10) |
| Net income | 74 | 128 | 110 | 73 |
| Earnings per common share: | | | | |
| Income before extraordinary charge (a) | $ 1.28 | $ 2.22 | $ 1.97 | $ 1.26 |
| Extraordinary charge, net of tax | — | — | (0.07) | — |
| Net income (a) | $ 1.28 | $ 2.22 | $ 1.90 | $ 1.26 |
| Earnings per common share assuming dilution: | | | | |
| Income before extraordinary charge (a) | $ 0.96 | $ 1.63 | $ 1.48 | $ 0.97 |
| Extraordinary charge, net of tax | — | — | (0.04) | — |
| Net income (a) | $ 0.96 | $ 1.63 | $ 1.44 | $ 0.97 |

(a) The sum of the four quarterly earnings per share amounts does not agree with the earnings per share as calculated for the full year due to the fact that the full year calculation uses a weighted average number of shares based on the sum of the four quarterly weighted average shares divided by four quarters.

During the second quarter of 1998, Continental recorded a $4 million after tax extraordinary charge relating to prepayment of debt.

During the third quarter of 1998, Continental recorded a fleet disposition/impairment loss of $122 million ($77 million after tax) relating to its decision to accelerate the retirement of certain jet and turboprop aircraft.

During the third quarter of 1997, in connection with the prepayment of certain indebtedness, Continental recorded a $4 million after tax extraordinary charge relating to early extinguishment of debt.

# Report of Independent Auditors

The Board of Directors and Stockholders
Continental Airlines, Inc.

We have audited the accompanying consolidated balance sheets of Continental Airlines, Inc. (the "Company") as of December 31, 1998 and 1997, and the related consolidated statements of operations, redeemable preferred stock and common stockholders' equity and cash flows for each of the three years in the period ended December 31, 1998. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company at December 31, 1998 and 1997, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 1998, in conformity with generally accepted accounting principles.

Ernst & Young LLP

Houston, Texas
January 20, 1999

## Board of Directors

Thomas J. Barrack, Jr.
*Chairman and Chief Executive Officer*
*Colony Advisors, Inc.*

Lloyd M. Bentsen, Jr.
*Former United States Senator*

Gordon M. Bethune
*Chairman and Chief Executive Officer*
*Continental Airlines, Inc.*

David Bonderman
*Managing Partner*
*Texas Pacific Group*

Gregory D. Brenneman
*President and Chief Operating Officer*
*Continental Airlines, Inc.*

Patrick Foley
*Chairman, President and Chief Executive Officer*
*DHL Airways, Inc.*

Douglas H. McCorkindale
*Vice Chairman and President*
*Gannett Co., Inc.*

George G. C. Parker
*Dean Witter Professor of Finance and Management*
*Associate Dean for Academic Affairs and*
*Director of the MBA Program*
*Graduate School of Business*
*Stanford University*

Richard W. Pogue
*Senior Advisor*
*Dix & Eaton*

William S. Price III
*Managing Partner*
*Texas Pacific Group*

Donald L. Sturm
*Chairman and Chief Executive Officer*
*Sturm Banks of Colorado, Inc.*

Karen Hastie Williams
*Partner*
*Crowell & Moring*

Charles A. Yamarone
*Executive Vice President*
*U.S. Bancorp Libra*

## Executive Officers and Key Employees

Gordon M. Bethune
*Chairman and Chief Executive Officer*

Gregory D. Brenneman
*President and Chief Operating Officer*

Lawrence W. Kellner
*Executive Vice President and Chief Financial Officer*

C.D. McLean
*Executive Vice President — Operations*

Jeffery A. Smisek
*Executive Vice President,*
*General Counsel and Secretary*

Michael H. Campbell
*Senior Vice President — Human Resources*
*and Labor Relations*

Mark A. Erwin
*Senior Vice President — Airport Services*

J. David Grizzle
*Senior Vice President — Corporate Development*

George L. Mason
*Senior Vice President — Technical Operations*

James B. Ream
*Senior Vice President — Asia*

Bonnie S. Reitz
*Senior Vice President — Sales and Distribution*

Barry P. Simon
*Senior Vice President — International*

Kuniaki Tsuruta
*Senior Vice President — Purchasing and*
*Material Services*

Janet P. Wejman
*Senior Vice President and Chief Information Officer*

David N. Siegel
*President — Continental Express, Inc.*

## Stockholder Information

**Headquarters**

Continental Airlines Inc.
1600 Smith Street
Houston, TX 77002
Tel. (713) 324-5000

**Investor Information**

To obtain a Form 10-K or other financial information, please write or call:

Investor Relations
Continental Airlines Inc.
P.O. Box 4607
Houston, TX 77210-4607
Tel. (713) 324-2241

**Transfer Agent and Registrar**

Harris Trust and Savings Bank
311 West Monroe
P.O. Box A3504
Chicago, IL 60690-3504
Attn: Shareholder Services

**Independent Auditors**

Ernst & Young LLP
One Houston Center
1221 McKinney
Houston, TX 77010-2007

**Common Stock**

Continental's Class B and Class A common stock trade on the New York Stock Exchange under the symbols CAI.B and CAI.A. As of February 17, 1999, there were 57,400,355 shares of Class B and 11,406,732 shares of Class A common stock outstanding, with approximately 15,494 holders of record of Class B and 2,953 holders of record of Class A.

Holders of Class B common stock are entitled to one vote per share, and holders of Class A common stock are entitled to ten votes per share, on all matters submitted to a vote of common stockholders, subject to restrictions governing voting rights of holders who are not United States citizens. Shares of Class A common stock are convertible at any time into an equal number of shares of Class B common stock. The Company has not paid cash dividends on its common stock and has no current intention to do so. Certain of the Company's credit agreements and indentures limit the ability of the Company and certain of its subsidiaries to pay cash dividends.

Following are the high and low sale prices for the Class B and Class A stock as reported on the New York Stock Exchange for 1998 and 1997:

## Class B and Class A Stock Prices for 1998 and 1997

| | Class B | | | | Class A | | | |
|---|---|---|---|---|---|---|---|---|
| | 1998 | | 1997 | | 1998 | | 1997 | |
| | High | Low | High | Low | High | Low | High | Low |
| First Quarter | $\$62\frac{1}{16}$ | $44 | $\$33\frac{5}{8}$ | $27 | $\$64\frac{1}{4}$ | $\$47\frac{3}{4}$ | $\$33\frac{3}{4}$ | $27 |
| Second Quarter | $64 | $\$54\frac{1}{16}$ | $\$35\frac{7}{8}$ | $\$29\frac{1}{2}$ | $\$64\frac{1}{2}$ | $\$55\frac{3}{4}$ | $\$36\frac{3}{4}$ | $\$30\frac{1}{8}$ |
| Third Quarter | $\$65\frac{1}{8}$ | $\$35\frac{3}{4}$ | $\$41\frac{3}{8}$ | $34 | $\$64\frac{3}{4}$ | $\$36\frac{1}{2}$ | $\$41\frac{7}{16}$ | $34 |
| Fourth Quarter | $\$42\frac{13}{16}$ | $\$28\frac{7}{8}$ | $\$50\frac{3}{16}$ | $\$38\frac{5}{8}$ | $\$43\frac{5}{16}$ | $\$30\frac{7}{8}$ | $\$50\frac{1}{2}$ | $\frac{1}{2}$ |

Continental Airlines