PERSONAL AND CONFIDENTIAL

AMERICAN AIRLINES INC.
CABLE ADDRESS AMAIR

100 EAST 42nd STREET · NEW YORK 17, NEW YORK · MURRAY HILL 5-3900

Washington, D. C.

February 26, 1946

To the Directors:

We have now all had the opportunity of thinking over the best method of raising $100,000,000.00, to provide for the forthcoming cash requirements of the company. It seems essential that we begin crystalizing our viewpoints on this subject, otherwise no preliminary work can be undertaken until after we have another meeting of the Board. One of the basic requirements of the financing program is to have our "paper work" in order as early as possible, to insure that we are ready to go when the opportune time for financing arrives. In order to now accomplish anything of real importance on the preparatory program it is essential that we have a reasonably definite viewpoint of what we hope to accomplish.

Additional Equity Requirement:

The consensus of the Board is that the company should acquire an additional amount of "equity" capital, capital which we are not required to repay and which can be considered a permanent part of our financial structure. This requirement can, obviously, be met through the issuance either of common or preferred stock.

Were we satisfied that the market will readily absorb common stock, and that the sale of the stock will bring a price which we consider to be reasonable, I believe that most of us would prefer the issuance of a reasonable amount of common stock.

On this score, it is well to remember that Aviation Corporation has the obligation of disposing of approximately 200,000 shares of our stock on or before the end of June, 1946. While this sale will neither increase the number of shares outstanding nor bring any funds into the treasury of American, the effect of putting this 200,000 shares on the market will have direct bearing upon the ability of the company to market additional shares during the same general period; this stock must be purchased by the public, the same people to whom we must go for the sale of additional shares.

In the discussion before the Board, consensus of the general trend was that we might well consider the issuance of a minimum of $50,000,000.00 common, 50% of the overall requirement, with maximum recommendation of $60,000,000.00. Taking the smaller figure and estimating net proceeds to be $80 per share, a figure not now possible, means the issuance of an additional 625,000 shares. Add to this the 200,000 shares which Aviation Corporation proposes to sell and we thus propose that the public market absorb 825,000 shares of American stock, with the hope that it will bring close to $80 per share. This, in my opinion, is wishful thinking, for I know of no evidence which will support the assumption that a market which has always been relatively thin, in our stock, will absorb an additional $66,000,000.00 without unduly depressing the market values.

I believe, therefore, that we engage in wishful thinking when we say to ourselves that we would "like" to sell an additional $50,000,000.00 in common during this year, with the known obligation of the market to absorb sales of $16,000,000.00 on behalf of Aviation Corporation. I believe that we should relieve ourselves of consideration of that projected program and turn to one better designed for reasonable success.

Amount of Additional Equity Required:

Assuming our present capital equity to be $25,000,000.00, what additional amount of equity is required in order to give us reasonable assurance of future financial security? Our belief is that an increase of this equity by 200% gives us the reasonable assurance which we require. I should say that $50,000,000.00 at this time would warrant our believing that we had approved a financial program of sensible security.

Preferred Stock as Constituting Equity:

Preferred stock does not have to be repaid. For that reason it fulfills the requirement for long term equity capital. The principal reason, in my opinion, for preferring an issue of this character is that it will afford us the opportunity, through conversion, of selling our common stock at a price higher than can be secured for common in the market today. For that ability, through the issuance of preferred shares, we take on the cumulative obligation of providing dividends at the rate of 3% per annum. While these preferred dividends remain always as an obligation which must ultimately be met, their temporary omission does not compare in seriousness with the omission of payments on fixed obligations. With respect to the ability to weather lean years, the ability to put off preferred dividends is not too much more serious than the omission of common dividends on a stock with a record of unbroken dividend payments.

Conversion of Preferred into Common:

The issuance of preferred with conversion features is predicated upon the assumption that the preferred, through conversion, will ultimately become common. In proposing a convertible preferred we would like to propose one which, over a reasonable period of time, will have reasonable opportunity of warranting conversion.

When the market settles down a bit the stock of American should sell without too much difficulty at around $80 per share. Assume a five to one split and no further increase and the market value of each share is $16. Let's use that figure for the purpose of this discussion.

We proposed that the stock should be convertible on the basis of $25 per share for the common. Over a period of a reasonable number of years, given a reasonable status of national stability and reasonable earnings for American, it is not unreasonable to believe that the common will sell at $25 per share, in spite of the fact that a 9 point rise will be required to reach that level. I do agree that we approach the outer limit of near future probability when we anticipate that figure, but we would like to avoid the mistakes made by companies like United and Aviation; making the conversion price so close to market that they deprive the company of securing the reasonable benefits of share appreciation. United sold its preferred

around par and it went to $150-160 within a very short time. Aviation Corporation sold its $50 preferred at par and it went to $76-80 within a short period of time. I think that we can agree that both of these companies would have fared better had their conversion price been somewhat higher at time of original issue.

It may be that the directors would like greater assurance that the preferred will be converted, and thus greater assurance that we are really selling common stock. This probably could be reasonably assured by making the conversion price $20 rather than $25; each share of preferred to be convertible into five shares of common rather than into four. On the basis of present shares, we would be offering conversion rights at $100 per share.

A check of the potential market will, I believe, disclose that 3% convertible preferred, conversion at $25, can be sold at par. No one can guarantee what a future market will be able to undertake but the best estimate today seems to be that 3%, $25 conversion preferred of American, could be sold at par. If that is true, it may be that 3%, $20 conversion, could be sold a bit above par. I doubt, however, that the difference in present sales price would be adequate compensation, to us, for the increased cost of conversion; conversion at $20 per share rather than $25.

Twenty-five Year Debentures:

Money from this source constitutes long term, not short term, money. The real objection that the directors raise is the unavoidable obligation of paying the annual interest. That, of course, cannot be avoided unless we undertake a program of full equity financing. On the basis that we do not want to undertake a full equity program, I know of no more effective method of raising your secondary money requirements. One feature in favor of the debenture is the right to deduct interest paid before the fixing of income taxes. That, presently, means a 38-40% absorption from taxes in years of profit, a feature not available either in common or preferred financing.

Ten Year Bank Loans:

The industry, for many years, has been considering the issuance of equipment trust obligations, or secured notes; notes used to raise money with which to pay approximately 80% of the cost of new equipment purchases, with the obligation to repay these notes over the estimated life of the equipment. I doubt that the estimated life of the equipment we now contemplate is going to be more than 6-8 years. On that basis a note secured by equipment would run for the same period.

If we want to engage in this form of financing, I would prefer the 10 year bank note, with negative pledge but no direct mortgage, to the shorter term chattel mortgage form. Some of the smaller companies will be required to go to the chattel mortgage form of financing but the superior credit position of American should preclude that requirement.

My recommendation:

I can see no requirement that we issue additional common stock at this time. I can see many reasons in favor of such a program but, likewise, there are many good

reasons why it should not be done. Were the management of this company interested only in attaining the utmost of financial security, we would recommend maximum equity financing. I do not believe, however, that we perform our duty to the stockholders by always adopting the course of utmost security; this is a growth business and I do not believe that we have yet reached the period where maximum financial security should be our program.

I recommend that we issue convertible preferred. I recommend that the dividend rate be $3. I ask your counsel on the conversion rate; if we want maximum assurance of conversion, perhaps the rate should be $20; if we want reasonable chance of conversion and high conversion rate, perhaps the rate should be $25, and if we want something in between, the rate can be adjusted but would be awkward from the standpoint of mathematical conversion.

I recommend that we issue $50,000,000.00; you may want to make this $30,000,000.00, and later borrow $20,000,000.00 from banks.

I recommend that we issue 2-3/4% non-convertible debentures, if they can be sold at par. The amount to be issued might well continue to be $50,000,000.00.

With respect to the bank loans, I am not sure that we need necessarily to decide that issue at this time. It is helpful for planning purposes to know where you hope to obtain the total of the $100,000,000.00 but it is not necessary that we secure the last $10,000,000.00 or $20,000,000.00 of the money until the latter part of the year. If, by that time, we have secured some $30-50 million from preferred and $50 million from debentures, I am sure that we would have no difficulty in selling ten year bank notes if we decided that to be the advantageous course.

Questions:

Do you have any objection to a split of 5 for 1? If so, what is it?

Will you recommend a program involving the sale of no common at this time, or as a part of this total $100,000,000.00 program? If not, what amount of common would you recommend that we sell, and why?

If we adopt the preferred as the basic equity financing, would you recommend $30 or $50 million? Do you agree that the preferred conversion rate should be set at whatever will permit a $3 rate?

If we shall include debentures, do you think that $30-40-50 millions is the appropriate amount? Is the rate of 2-3/4% sensible and appropriate?

In summary, what financial program would you advocate for the raising of $100 million? Make it $80 million now and $20 million in about a year and a half or two years if you prefer. Give detail of each security, and amount, which you would advocate; reasons also if you will. When answers have been received they will be summarized and sent to each director. This, it seems to me, is a sensible program for crystalizing our views and agreeing upon a program. No program will be formally passed until the next meeting but I think it would be well if we could have a program representing a consensus before that time.

Your counsel and aid will be gratefully received.

Sincerely yours,

C. R. Smith

D