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EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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Air Lease (AL) EQ Update- 9/20 Qtr.

Current EQ Rating*	Previous EQ Rating
4+	3-

6- "Exceptionally Strong"
5- "Strong"
4- "Acceptable"
3- "Minor Concern"
2- "Weak"
1- "Strong Concerns"

Note that a "+" sign indicates the earnings quality improved in the most recent quarter while a "–" sign indicates deterioration

*For an explanation of the EQ Review Rating scale, please refer to the end of this report

We are upgrading our rating on AL to 4+ (Acceptable) indicating improvement

AL missed forecasts by 6-cents on EPS and $29 million on revenue. In both cases, a change in revenue recognition is essentially the reason. The accounting is getting more conservative in our view. The company also raised its dividend and announced its first stock repurchase and remains in compliance of debt covenants and has liquidity of $7.2 billion. The full recovery of its airline customers may still be more than a year away, but **a lack of impairment charges is a good sign that AL's portfolio remains in demand and is a valuable asset.**

What Improved?

- Deferred rent payments are being received and those payments exceed new deferrals.
- Liquidity is high as capital needs are likely to continue coming in below forecast due to delays in new plane deliveries – AL announced a $100 million stock repurchase.
- EPS missed by 6-cents in 3Q. 19-cents is due to lower gains on aircraft sales and 17-cents is due to delaying revenue recognition on certain leases until cash is collected.

- AL has not seen any impairments on the value of its fleet – the worst of COVID appears over at this point.

What deteriorated?

- Customers are still paying late. Collections vs. Collections due fell from 91% in 2Q to 86% in 3Q.
- Both GAAP and Adjusted EPS include some one-time items such as canceled security deposits adding 4-cents in 1Q and buying notes back at a discount for 10-cents in 2Q.
- By not adjusting for gains on asset sales – adjusted EPS is now suffering because there are simply fewer asset sales and lower gains. This was a 19-cent hit to EPS in 3Q.

What to watch

- **AL is meeting debt covenants at essentially the levels seen pre-COVID.**
    - Equity must be > $2b – it is $6.0b and has risen this year.
    - Total Debt/Equity must be less than 3x and is at 2.3x.
    - Aircraft/unsecured debt > 125% - it is 140%
    - BBB- or greater debt rating. It is BBB, but is on negative watch

- Will more airlines restructure balance sheets that create additional delays in AL being paid?

Air Lease Changed Revenue Recognition on Some Leases to a Cash-Received Basis

AL has long-term leases on its planes with customers and it books revenue based on scheduled lease payments being due. With COVID – many of its airline customers have grounded planes and reduced service. The book is 73% leased to flag carriers of various countries where the government has an ownership stake in the airline. Those and others are receiving government financing deals as part of various COVID plans.

58% of its customers have received some sort of payment deferral plan from AL. Typically, these were 3-month deferrals that are now being repaid. **So far $60 million of the $201 million in deferred payment have been repaid, which is 30% of the total given. Repayments of deferred leases exceed the amount of current requests for deferrals. We consider this a sign of improvement for AL's business.** Also, customers who are working to cut costs are frequently culling older planes which burn more fuel and require more maintenance. That makes AL's planes highly desirable and customers want to keep them as they are new and more efficient.

At the same time, AL has to review the credit quality of its customers and assess how likely timely lease payments are. That can also include customers who are restructuring and want to keep the planes but may need to complete their restructuring before making payments for past rent. In that situation, collection of rent is not assured. In the 3Q, AL identified $25.3 million of lease payments that fit this situation. It is accounting for those leases as cash is received at this point. This is a change to a more conservative method of revenue recognition that takes these delays into account.

This $25.3 million in lease payments that were not recognized cost AL 17-cents in EPS and was the entire reason for the earnings miss. It also impacted the $29 million revenue miss.

While it appears the worst of COVID issues are ending with deferrals being repaid and we think AL has planes in high demand, AL still has airlines that are likely to do some significant restructuring before this is over. It currently has 19 planes with 5 airlines in this process already. It seems likely that more of this would be a pre-packaged type of bankruptcy where the negotiations happen out of court and the legal process is more of issue of giving it final approval. Thus, there could be more leases that require cash collection to recognize revenue before this is over. That may continue to pressure revenue in the coming quarters.

Cash Flow from Operations is down $254 million through 9-months of 2020 so far. We know much of this is due to these reasons. Deferred rent not yet collected is $141.7 million and the leases converted to **cash collection status for revenue recognition is $25.3 million**. That leaves an $87.0 million difference. **Accrued interest and payables are down $84.0 million** and rent received in advance is $3.4 million.

AL is still getting paid late. The collection rate was basically 90% in 1Q and 2Q and 86% in 3Q. This is defined as the amount of cash collected vs. the amount of receivables due. It adjusts for deferred rent and the change in revenue recognition in 3Q to lower the amounts due.

The Lack of Gains Impacted Earnings and Revenue Too

One area where we thought AL's adjusted EPS was aggressive is it adds back recurring items such as stock option expense and amortization of deferred debt issuance costs – but doesn't exclude gains on asset sales. Given that AL pays people with stock, continually finances new planes, and also is an active trader of planes – we would consider all of these to be recurring items and core parts of the results.

Where AL is suffering on results now is the volume of aircraft sales is down considerably. Thus, it is not booking the same level of gains or income from aircraft trading. Here are the trends for 2020:

	3Q20	2Q20	1Q20
Gains on Aircraft	$2.6	$4.9	$1.6
Gain on M-T Note	$0.0	$13.6	$0.0
Forfeited Deposits	$0.0	$0.0	$5.9
Per share	$2.6	$18.5	$7.5

Historically, gains on aircraft sales are about $30-$50 million for AL. This year there just are not many transactions as AL warned about in the 1Q20 10-Q:

> *"COVID-19 has disrupted some of our operations. While our employees are working remotely, due to travel restrictions and business limitations and shutdowns, **some transitions of our aircraft from one lessee to another lessee have been delayed. Some planned aircraft sales have been delayed or terminated** as a result of business limitations and shutdowns. We expect these disruptions to continue and they could worsen. We also expect that demand for used aircraft will decline in the near-term and that we will sell fewer used aircraft in 2020 and perhaps 2021 than we initially planned to sell."*

At the same time, it really did have some one-time events hit this year. In 1Q, customers backed out of deals and forfeiting deposits which were added into trading revenue. In 2Q, AL repurchased some medium-term notes at a discount and recognized a $13.6 million gain. Both of those were left in GAAP EPS and Adjusted EPS. For 1Q20 – the deposits added 4-cents to GAAP and Adjusted EPS. For 2Q20 – the gain on repurchasing notes at a discount added 10-cents to both EPS figures.

In 3Q20, there was only one plane sold. Gains of $2.6 million were down y/y from $30.2 million. That drop is 19-cents in EPS y/y for 3Q. That more than counts for the earnings miss in the quarter too.

We think the accounting at AL is fairly strong, except in this one area. If they continually add back recurring lumpy costs, they probably should be subtracting recurring lumpy gains from adjusted EPS. Because they don't do that way, they are getting hit on GAAP and Adjusted EPS when the gains disappear.

Liquidity Looks Solid

AL still has $7.2 billion in liquidity – cash on hand plus credit lines. The capital spending is likely to be lighter than expected because the Boeing 737-Max is not being produced now and the Airbus A320-neos have also had production delays. For the rest of 2020, AL has 14 planes scheduled for delivery but 7 are A320-neos. For 2021, AL has 63 planes scheduled for delivery, but 15 are Max and 32 are Neos. In 2020, they are expecting to have $2.5 billion in new planes vs. $6 billion that was originally forecast. Thus, they are carrying excess cash and liquidity.

Debt maturities are also not very heavy at $173 million for the rest of 2020 and $1.9 billion for 2021. The company's planes are in high demand because they are cheaper to operate due to lower fuel usage and newer making maintenance less costly too. Airlines looking to permanently lower costs are likely to retire more older planes at this time and with delays on getting newer planes – we doubt AL will have little difficulty rolling over debt or selling planes if necessary.

The company authorized its first stock repurchase of $100 million. That is enough to purchase about 2.5% of the stock. It also raised the dividend. From 15-cents to 16-cents.

Explanation of EQ Rating Scale

6- "Exceptionally Strong"	Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises
5- "Strong"	Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.
4- "Acceptable"	Indicates the company may have exhibited a minor "red flag", but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement
3- "Minor Concern"	Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.
2- "Weak"	Indicates the company's recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.
1- "Strong Concerns"	Indicates that the company's recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely.

In addition to the numerical rating, the EQ Review Rating may also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into the next quarter. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

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