BEHIND THE NUMBERS
Quality of Earnings Analysis

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February 26, 2021

Air Lease Corp. (AL) Earnings Quality Update

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We maintain our earnings quality rating of 4+ (Acceptable)

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

Summary

AL beat forecasts by 15-cents in 4Q. EPS was still down from $1.42 to $0.94 y/y. Adjusted EPS was $1.30 vs. $1.92. There are three main spots for the lower y/y earnings:

- AL had $21.2 million in rent due that it did not recognize because it was deemed uncertain to be collected or part of a lease being reworked. This was 15-cents of GAAP EPS and 19-cents of adjusted.

- AL's balance sheet is carrying more debt than normal as it boosted liquidity during Covid and delays in planes arriving from Boeing and Airbus. This higher interest expense hurt EPS by 5-cents and 6-cents. It also didn't produce as much lease income as expected.

- AL earns income by selling aircraft too. The volume of trading dropped off significantly from $44.2 million to $5.5 million. That in turn lowered SG&A, which fell by $10.9 million. AL does say much of that is from lack of trading transactions. There were $33 million in gains in 4Q19 and $0 in 4Q20. Just the y/y change in gains hurt EPS by 23 cents and adjusted EPS by 29 cents.

The fact that AL has not seen an impairment and its planes are in high demand are reasons we do not believe they have a fleet problem. The delays in new deliveries continue and that may make it difficult for AL's aircraft trading business to see normal volumes return in the near future.

What is strong?

- Collection rates improved to 88% in 4Q, compared to 86% in 3Q. Customer deferrals continue to be repaid. Most deferrals are a few months in duration. At the end of 3Q, AL noted it had received payments of $60 million on $201 million in deferrals. At the end of 4Q, $96 million has been collected on $240 million of deferrals.

- Customers continue to want to fly their planes with the lowest operating costs that are most efficient. These are often newer planes which is what AL specializes in. Even in the worst of Covid, AL planes were still flying and customers reworking fleets wanted to keep the new equipment. In our view, if AL made it through 2020 without impairments to fleet value, this risk should be lower going forward. The values are benefitting from high demand and long delays on delivery from Boeing and Airbus.

- The argument can be made that AL has too much liquidity at the moment. Normally, AL plans on having 80 new aircraft arrive worth $5-$6 billion per year and it sells 20-40 units to recycle some capital back into new planes covering about 20% of the cash needs. However, in 2020 only 26 new planes were delivered vs. 46 expected. AL only spent a net $2.5 billion in 2020 and that included buying 15 planes on the secondary market. It expects more delays in delivery for 2021 too. It is holding $1.7 billion in cash and an untapped $6 billion credit line to deal with capital needs. We prefer a liquid company over an illiquid one, but the $1.7 billion in cash is not making AL any money. Retiring $1.0 billion in debt would likely generate about 7-cents in quarterly EPS via reduced interest expense. Or AL could retire 20 million shares at $50 and add 23-cents in EPS per quarter. We're just illustrating these options to show there are some potential earnings tailwinds for AL going forward beyond simply having the airline market recover further. Even if they work down some of the cash in 2021 by paying cash for new planes – it should be more accretive to EPS than its standard model of financing the purchase.

What is weak?

- AL expects to see more lease deferral requests as well as requests for lease restructuring in early 2021. These situations normally include extending the lease term and can often

mean a sale-leaseback for additional planes with the client. These deals may result in more lease revenue over time, but early on, it may reduce total lease payments in 2021.

- When the leases are deferred, AL normally still records the lease revenue but does not collect the cash. As noted above, a growing percentage of the deferrals are being repaid. Only when AL cannot be assured of cash collection does it exclude recognizing lease income until cash is received. That is the $21.2 million in lower revenue for 4Q20.

- As delays from Boeing and Airbus continue, AL may not get the same number of planes it expects in 2021 or 2022. At the end of 2018, AL had 83 planes scheduled for delivery in 2020. That forecast was cut to 46 at the end of 2019. As noted above, only 26 arrived in 2020. Delays could reduce earnings growth. At the same time, AL is very disciplined in selling planes that begin to reach 7-8 years old. They sold 30 planes in 2017, 15 in 2018, and 30 in 2019. They sold only 8 in 2020. The sold figure should increase in the future and it may be tougher to replace the number of planes. They noted in the 10-K, *"Our aircraft sales program has been impacted by the pandemic, primarily because we elected to sell fewer aircraft in 2020 because of additional delivery delays of our new orderbook aircraft from Boeing and Airbus. We had no aircraft sales during the fourth quarter of 2020."*

What to watch

- AL is still issuing debt at lower rates. 93% of debt is unsecured senior notes. The company has about $2.0-$2.5 billion of debt maturing annually for the next several years. Every 50bp that AL sees in higher rates upon roll-over of each $2 billion would cost it about 2-cents in quarterly EPS.

- AL did note that where it could see a pick-up in business even amid slower rates of delivery is having more airlines opt to lease even new planes that they had expected to buy – Having the Leasing Market Grow as a percentage of the market. Essentially, AL's cost of capital is much lower than the airlines and it has more liquidity. Both situations could result in the airline still coming out ahead if it does more leasing with AL. To make this more clear, let's say there are 100 planes on order and Boeing only completes 50 or half the expected deliveries. AL has 40 of the planes and Airline Q has 30 of the 100. Basically, both would get half their order, 20 and 15. But if Airline Q decides it makes more financial sense to lease more of the 30 planes, AL could end up with as many as 35 planes despite the expected deliveries being off by 50%, and eventually it could gain as many as 70 instead of the expected 40.

According to Steve Hazy, the Executive Chairman on the call, ***"It also creates a situation where the airline recognizes that our cost of funds are significantly lower than what the airline has to pay. So in effect, even though we can have a very strong profit margin on these leases going forward, from the airlines point of view it is still a dramatic savings over what they would have to pay to finance their direct buy aircrafts.*** *So we're seeing this seismic shift for the lessors, both in terms of sale leaseback opportunities, which is less, our sort of appetite basket, but more towards filling in these gaps using our slots, our direct orders in the years to come. Particularly, right now the focus is on 2022 and 2023 and through the spring of 2024.* ***We're getting a lot of requests from airlines to kind of shift their order and backfill with Air Lease leases."***

"It will be an interesting process to see how balance sheets of companies on the airline and manufacturers side evolved. Despite most lessors experiencing margin pressure during the pandemic, many still have stronger credit ratings than the airlines that they service themselves, and we expect many will turn to the aircraft leasing companies to help finance the airline industry.

After years of being asked the question, 'when will leasing hit 50% of the market?' I can tell you as a fact that 55% of all aircraft deliveries by Airbus in the year 2020 were leased. So we are now at a point where we expect that aircraft lessors will finance 50% or more of all new aircraft deliveries going forward in the near future."

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 Concern)- 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 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 upcoming quarters. 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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