BEHIND THE NUMBERS
Quality of Earnings Analysis

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Air Lease Corp. (AL)
Earnings Quality Update- 12/21 Qtr.

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

We are maintaining our earnings quality rating of AL at 4+ (Acceptable) and maintain Top Buy rating.

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

Summary

AL's adjusted EPS of $1.75 in 4Q21 beat forecasts by 52 cents. Business improved in three ways:

- Aircraft sales perked up and generated $24 million in revenues. These were the first three aircraft sales in 2021, which have been missing all year given that delays from Boeing and Airbus deliveries led AL to hold planes longer. There is no breakdown of any costs associated with these sales. The maximum this could have generated is 21 cents in EPS for 4Q21. AL expects sales of used planes to rise during 2022 probably later in the year.

- AL also gained $30 million in lease revenue in 4Q from transitioning leases of five planes to different parties. The end of lease payments are the result and these happen from time to time. Often, AL sells planes before the lease expires as their normal operating model is built on buying new planes and selling them before they finish the first third of their useful lives to maintain higher value and desirable equipment. The fact that AL has slowed aircraft sales likely led to some of this. This was another 26 cents in EPS.

- Cash lease collections also rose to $12 million in the quarter. These are from customers where rent is not recognized until cash arrives. This has continued to improve since Covid and lease deferrals were heaviest. This added about 10 cents in total, but it wasn't zero before 4Q21. About 5 cents was incremental.

- We outline the risks of leases in Ukraine and Russia below. We believe AL should be able to withstand the potential risks there and think the market's reaction to exposure is overblown. We say that primarily because it is less than 5% of AL's total fleet, several are older planes, many Ukrainian planes were flown out of the country, and much of the business was impacted by delivery delays from Boeing and Airbus. Some contracts call for AL to deliver 7-9 planes to various customers with 0-2 actually with the airline now. We think the total risk to book value is between $5-$8 per share vs. the current value over $61.

- We still see AL with excess capital using its balance sheet to acquire more planes via sale-leasebacks from customers whose cost of capital is too high and rising vs. what AL is paying. AL is holding over $1 billion in cash and has a cost of capital of 2.79% now with 95% of that fixed rate. It will continue to receive new planes from Airbus and Boeing on a delayed basis.

- In our view, the market is getting past Covid issues and the deferred rent is now being collected. 99.3% of rent was collected in 4Q21. As the issues with aircraft manufacturing correct themselves, AL should be in a position to resume its full operating model which involves buying and placing about $6 billion in planes annually and selling a large number to recycle capital and generate trading revenue. For the last two years, it has been running at $3-$4 billion and AL has reduced aircraft sales as a result. It is worth noting that 4Q's $1.2 billion in new purchases were one-third of 2021's totals, so that is a positive sign.

- Basically, AL is a finance company that has seen its balance sheet only about two-thirds deployed the last two years with excess cash and balance sheet capacity acting as drags on results. We noted AL has two options – wait out Covid and travel restrictions with subpar earnings until the recovery begins, or reduce debt and share count to right-size the balance sheet to fit the smaller size of the operation. AL chose the first path and earnings are recovering. We think under either path, AL could see EPS top $5.00 per share, so the stock is trading for 60% of book and about 7x EPS.

Russia and Ukraine Special Risks

In recent weeks, Russia's invasion of Ukraine has hurt most of the airline leasing companies. This is based on the possibility that one of the planes could be shot down or destroyed in an attack on an airport. It also poses a risk of nationalization by Russia in retaliation for Western economic sanctions. Putin has said that Russia would do this and unless the plane was flown outside of the country – it would be much more difficult for the leasing company to recover it. Some of these airlines in the region are not flying at all right now – that can quickly ruin the cash flow stream to pay the leases. Finally, the collapse of the Ruble could lead to financial difficulty for the various airlines in Russia in terms of making lease payments, being able to afford fuel, and have passengers who can afford to fly at all.

We consider many of these risks to be real and could have a financial impact on AL's results and balance sheet. However, we believe AL has been overpenalized on this matter by the market in sympathy with competitors who have greater exposure. On its 4Q21 earnings call in February, AL noted it had less than 5% of the fleet with customers in Ukraine and Russia. AL also said that all its planes in Russia are not in state-owned airlines, which may make it easier to recover planes. We consider that a minor positive but not something that could not be overcome by the Russian government, which could simply nationalize all planes or the airlines operating them. Here are the reasons we think this is not a major issue for AL:

- "Less than 5% of the fleet" may actually be more like 2%-3%. There is $22.9 billion in net flight equipment on the balance sheet. Book value is $61.45 per share. Every 1% of net PP&E that would need to be written off is $1.61 per share in lower book value. The max 5% would be $8.05, the stock is under $37 so there is a solid cushion here.

- Many of the deals with Russian airlines have not been delivered. AL is supposed to deliver seven planes to Smart Avia – only one plane has entered their fleet so far. Azimuth has a contract for six planes during 2022 and 2023 – we think zero have arrived. S7 has received two planes of nine 737-MAX8's. It is possible that S7 has received all 4 of its A321-200 neo's from AL, but it still shows one on order. A deal for 737-MAX8s from UTair also looks unfulfilled. The delays from Boeing and Airbus in recent years have likely helped this situation. Other planes in Russia are older, like two used Airbus A300-200's that were delivered and could be over 10-12 years old. Those are worth less on the net

PP&E figure. Also, keep in mind that wide-body 787s and 777s cost more and likely carry a larger weight in the net PP&E figure than the narrow-body planes that the Ukrainian and Russian airlines are leasing. All that together may mean maximum exposure is about $5 in book value by our estimate.

- It is possible that exposure to Ukraine may be about equal to Russia. The largest part of the fleets of both UIA and Skyup are 737s that AL leases. We again found articles pointing to some of these planes being older (thus worth less than the average planes in AL's fleet). Of larger note, we found articles that pointed to Ukrainian planes losing insurance to fly some of their planes before the invasion started when the planes were already outside of Ukraine. UIA apparently proactively flew seven of its twelve 737s to Spain and Serbia before the invasion. We saw other articles indicating planes scheduled to return to Ukraine were diverted to other airports and didn't enter Ukraine. We cannot quantify this, but we believe a large percentage of Ukrainian aircraft are not in the country. This would seem to mitigate the risk of having the planes destroyed also.

- We would expect to see more information about this in 1Q22 earnings. Regardless of whether planes are nationalized or not, we do think many of the Ukrainian and Russian airlines will request lease deferrals or restructurings given they are not flying (or are on a much-reduced schedule). As we have discussed in past reports on AL – this means moving these leases to a cash basis. In the first period of this (1Q22), AL will stop accruing rent as revenue for these customers and will only record rent when it is received as cash. Revenue that may have been booked but not yet received such as in January will be reversed out of revenue and placed in deferred rent. If they need to restructure leases or take back planes, some deferred items may be written off. It is worth noting that the cash collection rate was 99.3% in 4Q21 so it is unlikely there is much to reverse from 2021 regarding Ukraine and Russia. But this could lower lease revenue in 1Q22.

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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