BEHIND
THE NUMBERS
Quality of Earnings Analysis

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Air Lease Corp. (AL)
Earnings Quality Update- 3/21 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 coverage of AL at 4+ (Acceptable).

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

Summary

After 4Q20 results, AL guided investors to expect more lease deferral requests in early 2021. The company did not guide investors to expect the level to jump enough for it to classify $48.7 million of rent due as uncertain from $21.2 million in 4Q. This cost adjusted EPS 43 cents in 1Q21 vs. 19 cents in 4Q20, and AL missed by 1-cent.

We did not lower the rating as AL still has considerable liquidity and continues to see earlier lease deferrals getting paid with total deferrals outstanding actually declining from $144 million to $131 million from 4Q. Plus, the accounting for the lease deferrals is still conservative in that AL waits until the cash is received – so this is more of a timing issue than a lack of payment.

What is strong?

- Liquidity is still over $7.5 billion and S&P moved the outlook up to stable for AL's investment grade rating. The company did lower debt by $351 million in the quarter with refinancing and the issuance of more preferred stock. The quarter saw AL fund its new aircraft purchases from cash on hand.

- Having significant excess cash/liquidity has been a COVID precaution. It is a drag on earnings because it adds interest expense without adding lease revenue. Starting to put some of that excess back to work is a positive sign in our view. Also, the new planes being acquired and leased are happening at pre-COVID contracted rates.

What is weak?

- The company saw its collection rate tick down slightly in 1Q also to 84% from 88% in 4Q. Some of that is tied to the new deferrals and restructurings in 1Q. The company's CEO noted on the earnings call that the pace of new requests for deferrals and restructuring has slowed meaningfully.

- Continued delays in manufacturing at Boeing and Airbus should continue to slow the speed at which AL fully recovers. The business model involves selling planes as they reach 7-8 years old and replacing them. AL sold only 8 planes in 2020 and that is likely to accelerate. Yet, it only took in 26 new planes in 2020 of an originally scheduled 83 for delivery in 2020. Chip shortages could also hamper some of the new aircraft production.

- AL is set up to complete a much larger number of transactions. The trading market for used aircraft may have bottomed at this point and could help going forward with some trading profits and also recycling capital by selling its own planes. Also, AL has talked about getting more sale-leaseback deals done with planes its customers currently own. Keeping so much excess liquidity during COVID was understandable. With that risk decreasing, the delays from Boeing and Airbus – which began long before COVID – may force AL to shrink its liquidity and balance sheet. That may mute the speed of the recovery for AL too.

What to Watch?

- We think the accounting and business model at AL is actually fairly conservative. Delaying revenue recognition until cash is received should give it some higher revenue and cash flow going forward. However, investors should be more focused at this time on how AL is going to grow earnings again. The company either needs to start adding new planes at a faster rate than recent years as its own fleet ages and that capital is recycled, or it will need to retire more debt and repurchase more stock to become a company that is the right size to initiate $2.5-$3.0 billion in new deals per year instead of $5-$6 billion.

- Our last update discusses some of this in more detail – such as leasing becoming a larger part of the overall market to help AL grow. Essentially, AL's cost of funds is far lower than many airlines, so the airlines may benefit from leasing more and owning fewer planes, or earnings can grow via retiring debt and cutting interest expense and/or repurchasing shares.

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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