BEHIND THE NUMBERS
Quality of Earnings Analysis
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Air Lease Corporation (AL)
Earnings Quality Update- 6/21 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) and maintaining our 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 $1.10 beat forecasts by 23-cents. The key reason for the beat was AL sold a receivable for deferred rent that was part of AeroMexico's bankruptcy. That was $34 million and was basically 24-cents of EPS. We continue to rate AL as a Top Buy idea. Delays in deliveries may hold back 3Q21 results but we believe AL can return to EPS well in excess of $5, making the P/E ratio under 8x. We see additional growth as airlines lease a higher percentage of their fleets and offsets delivery delays from Boeing and Airbus.

In most deferred rent situations, AL does not take a charge at all. It simply does not recognize the rental revenue until the cash is collected on a delayed basis. Thus, rental revenue may fall $15 million in Q4, another $15 million in Q1, and then in Q2 – the $15 million due is paid in cash along with $10 million of the $30 million that was deferred. If base revenue was $100 million per quarter – the rental revenue would look like this:

	Q2	Q1	Q4
Base Rent	$100	$100	$100
Deferred Rent	$0	-$15	-$15
Deferred Rent Collected	$10	$0	$0
Reported Rent Rev.	$110	$85	$85

In this situation, AL sold its claim to a third party – it wasn't paid rent that was collected in cash. Because it was a sale, it was reported in revenue from Aircraft Sales, Trading, and Other. Normally, that account is heavily weighted toward selling aircraft. But at $39.8 million, the bulk was obviously the $34 million sale of a claim against AeroMexico.

It is important to keep in mind that earnings are penalized by deferring rent because AL still has the expense of depreciation for the plane as well as interest expense. So margins decline during this time. As deferred rent is collected, it boosts margins and cash flow because again the expense is flat as more cash rent shows up as revenue. What is going on in AL's numbers at this point:

- The number of customers asking for rent relief is declining. The CEO said "the frequency of these requests is declining meaningfully." There was $42 million of rent that was moved to revenue recognition when cash is received in the 2Q. That is down from $49 million in 1Q. Also, of the $242 million of deferrals made since Covid, only $115 million have yet to be repaid at this point. That is down from $131 million in early May. Collecting the rest and having smaller new deferrals should boost revenues and cash flow as well as margins since the depreciation and interest expense incurred when the rent was deferred have already been recognized.

- In a deferred rent situation – AL essentially collects all the money it is owed – it simply is delayed for a quarter or two and the lease term may be extended.

- In 2Q21, AL also entered into $45 million of lease restructurings. Thus it did not recognize $87 million in rental revenue for the quarter ($45 million here and the $42 million that was deferred). In a restructuring, there is more give and take and is a larger deal. AL's newer planes remain highly desirable and the usage rate by its airline customers for AL planes is 99.7%. These are done on a case-by-case basis and can include:
    - Giving lower rent – but extending the term of the lease.
    - Agreeing to buy other planes from the customer – giving the customer a cash infusion and in turn leasing the new plane back to the customer.
    - Taking a plane back early and looking to lease it to a new customer.

- Restructuring may not result in AL receiving all scheduled cash. It can result in more total cash in some situations if the customer relationship is expanded. AL has spoken in the past that its cost of financing is much lower than the airline customers and it believes leasing will become more prevalent for fleets going forward. Some of these restructurings may facilitate faster growth in the future.

- While we saw the $34 million of AeroMexico cash come in via a different way that helped EPS by 24-cents, the $87 million of deferred and restructuring rent cost AL about 62-cents in EPS. Some of that will come back as higher future cash rent while the expenses were already booked in 2Q21.

- AL was also hurt in the quarter again by delayed deliveries of new aircraft. It took delivery of only $1 billion of the expected $1.2 billion. Also, half of the $1 billion arrived in June and had a lesser impact on results than expected. So this was a headwind for earnings too.

- We have pointed out in previous reports that AL's operating model is to buy new planes and sell planes as they reach essentially 6-8 years of age. Trading aircraft – both its own planes and those for other portfolios – has often been a reasonable part of EPS. However, with Covid, trading largely disappeared. Recent gains reported in this area have focused on items like selling the AeroMexico claim or refinancing debt. AL is planning to counter the delays in deliveries of new planes by delaying aircraft sales for the rest of 2021 and perhaps into early 2022. This could make this source of revenue and earnings depressed for 2-4 more quarters. The CEO noted:

  *"Given these OEM delivery delays, **we will significantly scale back our aircraft sales for the remainder of this year and possibly into early 2022**. And for our growth and to help fill this shortfall in aircraft investments, we see the current environment continuing to favor buying attractive assets versus selling them."*

- Overall, the situation appears to be improving in that deferrals and restructurings are likely closer to being completed than started. AL expects to collect deferred rent by the end of 2022. That will help margins and cash flow recover going forward. For us, the bigger headwind remains delays from Boeing and Airbus. AL has a balance sheet that can put almost twice as many planes in the portfolio every year than it is currently receiving.

- We have a 4+ rating here because the accounting is conservative and the company has significant liquidity. At some point, AL will either need to find ways to expand the number of planes it has with more sale-leasebacks with customers or it can retire debt and shares

and grow EPS with the current fleet. We think either way – there should be more potential for improvement in the results.

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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