BEHIND THE NUMBERS
Quality of Earnings Analysis

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Air Lease Corp. (AL)
Earnings Quality Update

We are maintaining our earnings quality rating of SWK of 4+ (Acceptable)

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

Summary

Air Lease's (AL) 4Q23 adjusted EPS of $1.92 beat estimates by 31 cents. Keep in mind that adjusted EPS backs out the $67.0 million of insurance recoveries on four planes nationalized in Russia. Other parts of the business continue to recover to drive additional earnings as well:

- We would watch for some lumpy areas that normally hit at the end of the year when aircraft sales are heavier. We doubt 2024 sees as much overhaul revenue:
    - Overhaul revenue is paid to AL by its customers and is used to do larger maintenance when a lease ends and the plane transfers back to AL. Lease terms vary with many paying this fee monthly during the lease and others delivering a large payment at the end. For 2023, this jumped to $167.3 million from $27.8 million in 2022 and $44.2 million in 2021. In 2022, there was also the recognition of $68.8 million of forfeited deposits related to the nationalized Russian planes. We just want to point this out because while this is a lumpy revenue item, it is rarely as high as it was in 2023 and it was $60 million in 4Q23. There are amortization costs and direct expenses that consume some of the $60 million – so it does not flow completely to the bottom line.

    - Gains are returning from selling planes as well. We do not expect these to vanish again. AL has a backlog of future sales coming. However, it's worth noting that gains jumped to $59 million in 4Q23 vs. $28 million in 4Q22. Normally, these are heavier later in the year. But AL is matching against years with very few aircraft sales so the gains look more pronounced now.

- Many focus on the current interest cost for AL – noting that interest rates have increased and will boost its cost of funds as debt rolls over. We think this view is misinformed:
    - AL locks in a lease rate when the plane is delivered. Its customers are B-rated credits and it is BBB-rated. The spread between B and BBB is still 200bp.
    - AL's current cost of borrowing is 3.77% and 85% fixed rate vs. the current BBB bond at 5.57% - it already has an additional 180bp of spread going into new deals.
    - For deals completed in 2021-2023, the B to BBB spread has been 300bp and its balance sheet was giving AL an additional 200-300bp of spread between its fixed borrowing rate and the BBB rate at the time.
    - Leases are for 7-10 years in most cases. The shortage of planes available and rising passenger loads are causing lease renewals to be done at higher rates too. Historically, 75% of AL's leases are extended. Now, it's 90%-95%. On the earnings call, AL noted that extensions are coming in at higher lease rates than the original.
    - Only about 12%-15% of AL's debt rolls over in any given year. Some of that will roll at a higher rate of course, but the leases are increasing too and there are still two different interest spreads at work here and both are favorable to AL.

- Aircraft sales are returning. AL's operating model is to buy new planes and sell them within the first third of life about year 7-10 to recycle the capital. The manufacturing problems at Boeing, Airbus, and the engine builders have delayed delivery of new planes for years. As a result, AL kept some planes longer in years 2020-2022.
    - The company had been running without a key source of income. AL sold 30 planes in 2019. That dropped to 8 in 2020 and 3 in 2021. In 2023, it returned to 27. Gains also amounted to $156.3 million.
    - Proceeds of aircraft sales are used to retire debt as the company works to reduce debt to 2.5x book value. It was at 2.69x at the end of 2022 and 2.61x at the end of 2023.

- The gains amounted to $1.40 of AL's adjusted EPS of $6.58. We think the rising lease rates, the strong demand to extend leases at higher rates, and the gains on the sale of used planes all point to the depreciated value of the planes on AL’s balance sheet as being understated.

- A further point to make in that area is many of AL’s planes that are delayed in arriving were ordered before inflation and before the mass ordering by many airlines. AL was able to get bargain deals for placing large orders at the time. We believe it is bringing new planes on the balance sheet at a cost point below fair market value.

- Every 1% discount on the $26.3 billion in plane valuation on the balance sheet is worth $2.35/share. It’s easy to make a case of $10-$15 in our view.

- Before accounting for any Fair Market Value or adding in potential recoveries on additional Russian planes, AL’s book value is $64 per share and the current stock price is $46.

- Book value was negatively impacted by about $5 when AL wrote off its Russian planes in 2022. In late 2023, it recovered about 9% of that with insurance settlements involving four planes. Legal work continues with other insurance companies to recover more of the loss which could further boost book value.

- We would also note that AL has been clear that it has remedies for compensation for the excessive delays in order deliveries from Boeing and Airbus. It intends to pursue that which should boost book value too.

- There are also other companies in line for Boeing and Airbus orders whose spot may say delivery in 2028, but that could mean 2032 instead. AL could likely sell spots in line for planes that may arrive in 2026 and take the later spot as well. That would be another area to see some monetization of current orders that would have a positive impact on book value.

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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