

WILLIS LEASE FINANCE CORP

Form 10-Q

November 07, 2018

Table of Contents

f

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

---

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the Quarterly Period Ended September 30, 2018

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

Commission File Number: 001-15369

---

WILLIS LEASE FINANCE CORPORATION

Edgar Filing: WILLIS LEASE FINANCE CORP - Form 10-Q

(Exact name of registrant as specified in its charter)

Delaware  
(State or other jurisdiction of incorporation or organization)

68-0070656  
(IRS Employer Identification No.)

4700 Lyons Technology Parkway, Coconut Creek, FL  
(Address of principal executive offices)

33073  
(Zip Code)

Registrant's telephone number, including area code (415) 408-4700

---

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See definitions of "large accelerated filer," "accelerated filer", "non-accelerated filer", "smaller reporting company" and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer	Accelerated filer
Non-accelerated filer	Smaller reporting company
Emerging growth company	

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date:

Title of Each Class	Outstanding at November 5, 2018
Common Stock, \$0.01 par value per share	6,208,941

Table of Contents

WILLIS LEASE FINANCE CORPORATION  
AND SUBSIDIARIES

INDEX

<u>PART I. FINANCIAL INFORMATION</u>	4
<u>Item 1. Condensed Consolidated Financial Statements (Unaudited)</u>	4
<u>Condensed Consolidated Balance Sheets as of September 30, 2018 and December 31, 2017</u>	4
<u>Condensed Consolidated Statements of Income for the three and nine months ended September 30, 2018 and 2017</u>	5
<u>Condensed Consolidated Statements of Comprehensive Income for the three and nine months ended September 30, 2018 and 2017</u>	6
<u>Condensed Consolidated Statements of Cash Flows for the nine months ended September 30, 2018 and 2017</u>	7
<u>Notes to Condensed Consolidated Financial Statements</u>	8
<u>Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations</u>	22
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	28
<u>Item 4. Controls and Procedures</u>	28
<u>PART II. OTHER INFORMATION</u>	29
<u>Item 1A. Risk Factors</u>	29
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	29
<u>Item 5. Other Information</u>	30
<u>Item 6. Exhibits</u>	31

Table of Contents

SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q contains certain forward-looking statements, including, without limitation, statements concerning the conditions in our industry, our operations, our economic performance and financial condition, including, in particular, statements relating to our business, operations, growth strategy and service development efforts. The Private Securities Litigation Reform Act of 1995 provides a “safe harbor” for certain forward-looking statements so long as such information is identified as forward-looking and is accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those projected in the information. When used in this Quarterly Report on Form 10-Q, the words “may,” “might,” “should,” “estimate,” “project,” “plan,” “anticipate,” “expect,” “intend,” “outlook,” “believe” and other similar expressions are intended to identify forward-looking statements and information. You are cautioned not to place undue reliance on these forward-looking statements, which speak only as of their dates. These forward-looking statements are based on estimates and assumptions by our management that, although we believe to be reasonable, are inherently uncertain and subject to a number of risks and uncertainties. These risks and uncertainties include, without limitation, those in our Annual Report on Form 10-K for the year ended December 31, 2017 filed with the Securities and Exchange Commission (SEC) on March 15, 2018 and our other reports filed with the SEC. We undertake no obligation to publicly update or revise any forward-looking statement as a result of new information, future events or otherwise, except as otherwise required by law. Reference is also made to such risks and uncertainties detailed from time to time in our other filings with the SEC.

Table of Contents

## PART I — FINANCIAL INFORMATION

## Item 1. Condensed Consolidated Financial Statements (Unaudited)

WILLIS LEASE FINANCE CORPORATION  
AND SUBSIDIARIES

## Condensed Consolidated Balance Sheets

(In thousands, except per share data)

(Unaudited)

	September 30, 2018	December 31, 2017
<b>ASSETS</b>		
Cash and cash equivalents	\$ 8,436	\$ 7,052
Restricted cash	155,420	40,272
Equipment held for operating lease, less accumulated depreciation of \$392,444 and \$368,683 at September 30, 2018 and December 31, 2017, respectively	1,590,482	1,342,571
Maintenance rights	14,763	14,763
Equipment held for sale	40,931	34,172
Operating lease related receivables, net of allowances of \$1,823 and \$949 at September 30, 2018 and December 31, 2017, respectively	24,777	18,848
Spare parts inventory	24,409	16,379
Investments	44,438	50,641
Property, equipment & furnishings, less accumulated depreciation of \$8,770 and \$7,374 at September 30, 2018 and December 31, 2017, respectively	26,245	26,074
Intangible assets, net	1,430	1,727
Other assets	33,865	50,932
Total assets (1)	\$ 1,965,196	\$ 1,603,431
<b>LIABILITIES, REDEEMABLE PREFERRED STOCK AND SHAREHOLDERS' EQUITY</b>		
Liabilities:		
Accounts payable and accrued expenses	\$ 40,879	\$ 22,072
Deferred income taxes	87,142	78,280
Debt obligations	1,392,113	1,085,405
Maintenance reserves	88,986	75,889
Security deposits	28,591	25,302
Unearned revenue	7,264	8,102
Total liabilities (2)	1,644,975	1,295,050

Redeemable preferred stock (\$0.01 par value, 2,500 shares authorized; 2,500 shares issued at September 30, 2018 and December 31, 2017, respectively)	49,533	49,471
Shareholders' equity:		
Common stock (\$0.01 par value, 20,000 shares authorized; 6,230 and 6,419 shares issued at September 30, 2018 and December 31, 2017, respectively)	62	64
Paid-in capital in excess of par	—	2,319
Retained earnings	269,664	256,301
Accumulated other comprehensive income, net of income tax expense of \$273 and \$83 at September 30, 2018 and December 31, 2017, respectively	962	226
Total shareholders' equity	270,688	258,910
Total liabilities, redeemable preferred stock and shareholders' equity	\$ 1,965,196	\$ 1,603,431

- 
- (1) Total assets at September 30, 2018 and December 31, 2017, respectively, include the following assets of variable interest entities (“VIEs”) that can only be used to settle the liabilities of the VIEs: Cash \$393 and \$130; Restricted cash \$155,420 and \$40,272; Equipment \$1,054,258 and \$657,333; and Other assets \$834 and \$20,090, respectively.
- (2) Total liabilities at September 30, 2018 and December 31, 2017, respectively, include the following liabilities of VIEs for which the VIEs’ creditors do not have recourse to Willis Lease Finance Corporation: Debt obligations \$919,026 and \$577,056, respectively.

See accompanying notes to the unaudited condensed consolidated financial statements.

Table of Contents

## WILLIS LEASE FINANCE CORPORATION

## AND SUBSIDIARIES

## Condensed Consolidated Statements of Income

(In thousands, except per share data)

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
<b>REVENUE</b>				
Lease rent revenue	\$ 46,984	\$ 33,474	\$ 129,710	\$ 95,045
Maintenance reserve revenue	19,370	20,370	56,855	64,212
Spare parts and equipment sales	8,354	9,294	21,701	41,273
Gain on sale of leased equipment	1,256	174	2,142	4,684
Other revenue	2,010	2,549	5,762	6,439
Total revenue	77,974	65,861	216,170	211,653
<b>EXPENSES</b>				
Depreciation and amortization expense	19,861	16,142	55,600	48,786
Cost of spare parts and equipment sales	5,848	7,148	16,537	32,121
Write-down of equipment	1,215	6,226	4,793	19,668
General and administrative	18,124	14,308	50,517	40,574
Technical expense	2,290	2,605	9,199	7,345
Interest expense	17,885	14,220	46,617	36,398
Total expenses	65,223	60,649	183,263	184,892
Earnings from operations	12,751	5,212	32,907	26,761
Earnings from joint ventures	506	3,040	1,569	6,055
Income before income taxes	13,257	8,252	34,476	32,816
Income tax expense	3,583	2,960	9,359	13,367
Net income	9,674	5,292	25,117	19,449
Preferred stock dividends	819	344	2,431	988
Accretion of preferred stock issuance costs	21	9	62	25
Net income attributable to common shareholders	\$ 8,834	\$ 4,939	\$ 22,624	\$ 18,436
Basic weighted average earnings per common share	\$ 1.50	\$ 0.82	\$ 3.80	\$ 3.04
Diluted weighted average earnings per common share	\$ 1.47	\$ 0.80	\$ 3.72	\$ 2.97
Basic weighted average common shares outstanding	5,900	6,055	5,960	6,068
Diluted weighted average common shares outstanding	6,004	6,184	6,083	6,215

See accompanying notes to the unaudited condensed consolidated financial statements.

5

---

Table of Contents

## WILLIS LEASE FINANCE CORPORATION

## AND SUBSIDIARIES

## Condensed Consolidated Statements of Comprehensive Income

(In thousands)

(Unaudited)

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2018	2017	2018	2017
Net income	\$ 9,674	\$ 5,292	\$ 25,117	\$ 19,449
Other comprehensive (loss) income:				
Currency translation adjustment	(530)	294	(762)	620
Unrealized gain on derivative instruments	221	164	1,636	160
Net (loss) gain recognized in other comprehensive income	(309)	458	874	780
Tax benefit (expense) related to items of other comprehensive income	70	(158)	(197)	(270)
Impact from adoption of ASU 2018-02 (1)	—	—	59	—
Other comprehensive (loss) income	(239)	300	736	510
Total comprehensive income	\$ 9,435	\$ 5,592	\$ 25,853	\$ 19,959

(1) Reflects the stranded tax effects from change in tax rate as a result of the early adoption of ASU 2018-02 which has been reclassified to retained earnings.

See accompanying notes to the unaudited condensed consolidated financial statements.

Table of ContentsWILLIS LEASE FINANCE CORPORATION  
AND SUBSIDIARIES

## Condensed Consolidated Statements of Cash Flows

(In thousands)

(Unaudited)

	Nine Months Ended September 30,	
	2018	2017
Cash flows from operating activities:		
Net income	\$ 25,117	\$ 19,449
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization expense	55,600	48,786
Write-down of equipment	4,793	19,668
Stock-based compensation expenses	4,004	3,228
Amortization of deferred costs	4,143	3,639
Allowances and provisions	1,022	282
Gain on sale of leased equipment	(2,142)	(4,684)
Gain on insurance settlement	—	(1,288)
Income from joint ventures	(1,569)	(6,055)
Deferred income taxes	9,359	13,367
Changes in assets and liabilities:		
Receivables	(6,951)	(220)
Distributions received from joint ventures	5,540	1,880
Spare parts and equipment	(27,537)	7,021
Other assets	(3,173)	(1,692)
Accounts payable and accrued expenses	13,472	(687)
Maintenance reserves	16,431	1,706
Security deposits	3,519	6,651
Unearned revenue	(838)	990
Net cash provided by operating activities	100,790	112,041
Cash flows from investing activities:		
Proceeds from sale of equipment (net of selling expenses)	51,600	53,849
Distributions received from joint ventures	190	—
Purchase of equipment held for operating lease	(320,186)	(177,263)
Purchase of property, equipment and furnishings	(1,574)	(493)
Net cash used in investing activities	(269,970)	(123,907)
Cash flows from financing activities:		
Proceeds from issuance of debt obligations	616,439	485,700
Debt issuance cost	(6,068)	(7,473)
Principal payments on debt obligations	(306,800)	(448,237)

Edgar Filing: WILLIS LEASE FINANCE CORP - Form 10-Q

Interest bearing security deposits	—	(3,261)
Proceeds from shares issued under stock compensation plans	292	177
Cancellation of restricted stock units in satisfaction of withholding tax	(1,252)	(747)
Repurchase of common stock	(14,459)	(3,546)
Proceeds from the issuance of preferred stock	—	29,700
Preferred stock dividends	(2,440)	(891)
Net cash provided by financing activities	285,712	51,422
Increase in cash, cash equivalents and restricted cash	116,532	39,556
Cash, cash equivalents and restricted cash at beginning of period	47,324	32,374
Cash, cash equivalents and restricted cash at end of period	\$ 163,856	\$ 71,930
Supplemental disclosures of cash flow information:		
Net cash paid for:		
Interest	\$ 44,990	\$ 31,932
Income Taxes	\$ 1,074	\$ 346
Supplemental disclosures of non-cash activities:		
Purchase of aircraft and engines	\$ 3,600	\$ 2,931
Transfers from Equipment held for operating lease to Equipment held for sale	\$ 6,995	\$ 36,285
Accrued preferred stock dividends	\$ 819	\$ 988

See accompanying notes to the unaudited condensed consolidated financial statements.

Table of Contents

WILLIS LEASE FINANCE CORPORATION

AND SUBSIDIARIES

Notes to Condensed Consolidated Financial Statements

September 30, 2018

(Unaudited)

Unless the context requires otherwise, references to “the “Company”, “we”, “us” or “our” in this Quarterly Report on Form 10-Q refer to Willis Lease Finance Corporation and its subsidiaries.

1. Summary of Significant Accounting Policies

The significant accounting policies of the Company were described in Note 1 to the audited consolidated financial statements included in the Company’s 2017 Annual Report on Form 10-K (“2017 Form 10-K”). There have been no significant changes in the Company’s significant accounting policies for the nine months ended September 30, 2018.

(a) Basis of Presentation

The accompanying Unaudited Condensed Consolidated Financial Statements of the Company have been prepared in conformity with accounting principles generally accepted in the United States (“GAAP”) for interim financial information and in accordance with the rules and regulations of the Securities and Exchange Commission. Therefore, they do not include all information and footnotes normally included in annual consolidated financial statements and should be read in conjunction with the consolidated financial statements and notes thereto included in the 2017 Form 10-K. In the opinion of management, the Unaudited Condensed Consolidated Financial Statements contain all adjustments (consisting principally of normal recurring accruals) necessary for a fair presentation of the condensed consolidated balance sheets, statements of income, statements of comprehensive income and statements of cash flows for such interim periods presented. Additionally, operating results for interim periods are not necessarily indicative of the results that can be expected for a full year.

In accordance with GAAP, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. In preparing these financial statements, management has made its best estimates and judgments of certain amounts included in the financial statements, giving due consideration to materiality. These estimates and judgments are based on historical experience

and other assumptions that management believes are reasonable. However, application of these accounting policies involves the exercise of judgment and use of assumptions as to future uncertainties and, as a result, actual results could differ materially from these estimates. The significant estimates made in the accompanying Unaudited Condensed Consolidated Financial Statements include certain assumptions related to goodwill, intangible assets, long-lived assets, equipment held for sale, estimated income taxes and stock-based compensation. Actual results may differ from these estimates under different assumptions or conditions.

(b) Reclassifications

In conjunction with our review of the fourth quarter of 2017, the Company reclassified scrap inventory write-offs and inventory lower of cost or market write-downs that were previously presented within Write-down of equipment to the Cost of spare parts and equipment sales line item. The three and nine month periods ended September 30, 2017 were impacted by an adjustment of \$0.7 million and \$2.6 million, respectively, with the adjustment reflected as an increase to Cost of spare parts and equipment sales and a decrease to Write-down of equipment. These reclassified items had no effect on the reported results of operations, financial condition or statements of cash flows.

(c) Principles of Consolidation

The accompanying consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries, including VIEs where the Company is the primary beneficiary in accordance with consolidation guidance. The Company evaluates all entities in which it has an economic interest firstly to determine whether for accounting purposes the entity is a variable interest entity or voting interest entity. If the entity is a VIE the Company consolidates the financial statements of that entity if it is the primary beneficiary of the entities' activities. If the entity is a voting interest entity the Company consolidates the entity when it has a majority of voting interests. Intercompany transactions and balances have been eliminated in consolidation.

Table of Contents

(d) Recent Accounting Pronouncements

Recent Accounting Pronouncements Adopted by the Company

In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standard Update (“ASU”) 2014-09, “Revenue from Contracts with Customers” (“ASU 2014-09”). ASU 2014-09 amends the accounting guidance on revenue recognition. The amendments in this accounting standard update are intended to provide a more robust framework for addressing revenue issues, improve comparability of revenue recognition practices, and improve disclosure requirements. Under the new standard, revenue is recognized when a customer obtains control of promised goods or services and is recognized in an amount that reflects the consideration which the entity expects to receive in exchange for those goods or services. The principles in the standard should be applied using a five-step model that includes 1) identifying the contract(s) with a customer, 2) identifying the performance obligations in the contract, 3) determining the transaction price, 4) allocating the transaction price to the performance obligations in the contract, and 5) recognizing revenue when (or as) the performance obligations are satisfied. The standard also requires disclosure of the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. In addition, the standard amends the existing requirements for the recognition of a gain or loss on the transfer of nonfinancial assets that are not in a contract with a customer (for example, sales of real estate) to be consistent with the standard’s guidance on recognition and measurement (including the constraint on revenue). The FASB also subsequently issued several amendments to the standard, including clarification on principal versus agent guidance, identifying performance obligations, and immaterial goods and services in a contract.

The Company adopted ASU 2014-09 and its related amendments (collectively known as Accounting Standards Codification (“ASC”) 606) effective on January 1, 2018 using the modified retrospective approach applied only to contracts not completed as of the date of adoption. Please see Note 2 "Revenue from Contracts with Customers" for the required disclosures related to the impact of adopting this standard and a discussion of the Company's updated policies related to revenue recognition and accounting for costs to obtain and fulfill a customer contract.

In August 2016, the FASB issued ASU 2016-15, Statement of Cash Flows (Topic 230), Classification of Certain Cash Receipts and Cash Payments a consensus of the Emerging Issues Task Force) to improve the diversity in practice in how certain cash receipts and cash payments are presented and classified in the statement of cash flows. The update provides guidance on specific cash flow classification issues including the following: (1) debt prepayment or debt extinguishment costs; (2) settlement of zero-coupon debt instruments or other debt instruments with coupon interest rates that are insignificant in relation to the effective interest rate of the borrowing; (3) contingent consideration payments made after a business combination; (4) proceeds from the settlement of insurance claims; (5) proceeds from the settlement of corporate-owned life insurance policies, including bank-owned life insurance policies; (6) distributions received from equity method investees; (7) beneficial interests in securitization transactions; and (8) separately identifiable cash flows and application of the predominance principle. Prior GAAP did not include specific guidance on these eight cash flow classification issues. The Company adopted the guidance effective January 1, 2018 and utilizing the cumulative earnings approach on a retrospective basis, reclassified \$1.9 million of distributions from

joint ventures during the nine months ended September 30, 2017 from cash flows from investing activities to cash flows from operating activities. The remaining provisions of this update did not have a material impact on the Company's consolidated statements of cash flows.

In January 2017, the FASB issued ASU 2017-04, "Intangibles—Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment," that eliminates "Step 2" from the goodwill impairment test. The Company has made the election to early adopt ASU 2017-04 as of January 1, 2018 and the standard was applied on a prospective basis, as required. The adoption of this standard did not have an impact on the consolidated financial statements or the related disclosures.

In May 2017, the FASB issued ASU 2017-09, "Compensation—Stock Compensation (Topic 718): Scope of Modification Accounting," that provides guidance about which changes to the terms or conditions of a share-based payment award require an entity to apply modification accounting. The new guidance became effective for the Company on January 1, 2018 and was applied on a prospective basis, as required. The adoption of this standard did not have an impact on the consolidated financial statements or the related disclosures.

In February 2018, the FASB issued ASU 2018-02, "Income Statement – Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income" to address

Table of Contents

stakeholder concerns about the guidance in current GAAP that requires deferred tax liabilities and assets to be adjusted for the effect of a change in tax laws or rates with the effect included in income from continuing operations in the reporting period that includes the enactment date. The amendments in this update allow a reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the Tax Cuts and Jobs Act of 2017. The ASU must be applied either in the period of adoption or retrospectively to each period in which the effect of the change in the U.S. federal corporate income tax rate in the Act is recognized. The Company made the election to early adopt ASU 2018-02 as of January 1, 2018 (the period of adoption) and recorded a reclassification of \$59 thousand between Other comprehensive income and Retained earnings as of January 1, 2018.

In September 2018, the FASB issued ASU 2018-15, “Intangibles – Goodwill and Other – Internal-Use Software (Subtopic 350-40): Customer’s Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract” which requires cloud computing arrangements in a service contract to follow the internal-use software guidance provided by ASC 350-40 in determining the accounting treatment of implementation costs. ASC 350-40 states that only qualifying costs incurred during the application development stage may be capitalized. The Company made the election to early adopt ASU 2018-15 on a retrospective basis, and during 2018 has capitalized \$1.0 million in cloud computing arrangement implementation costs. There was no prior period impact related to the adoption of ASU 2018-15.

Recent Accounting Pronouncements To Be Adopted by the Company

In August 2017, the FASB issued ASU 2017-12, “Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities.” The ASU is targeted at simplifying the application of hedge accounting and aims at aligning the recognition and presentation of the effects of hedge instruments and hedge items. ASU 2016-02 is effective for interim and annual periods beginning after December 15, 2018, with early adoption permitted. The Company plans to adopt this guidance effective January 1, 2019 and is currently evaluating the potential impact adoption will have on the consolidated financial statements and related disclosures.

In February 2016, the FASB issued ASU 2016-02, “Leases (Topic 842)” (“ASU 2016-02”). The FASB issued ASU 2016-02 to increase transparency and comparability among organizations recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. Under ASU 2016-02, lessors will account for leases using an approach that is substantially equivalent to existing GAAP for sales-type leases, direct financing leases and operating leases. Unlike current guidance, however, a lease with collectability uncertainties may be classified as a sales-type lease. If collectability of lease payments, plus any amount necessary to satisfy a lessee residual value guarantee, is not probable, lease payments received will be recognized as a deposit liability and the underlying assets will not be derecognized until collectability of the remaining amounts becomes probable. ASU 2016-02 is effective for interim and annual periods beginning after December 15, 2018, with early adoption permitted, and must be adopted using a modified retrospective transition. The Company plans to adopt this guidance effective January 1, 2019 utilizing the lessor practical expedient and is currently evaluating the potential impact adoption will have on the consolidated financial statements and related disclosures.

## 2. Revenue from Contracts with Customers

As of January 1, 2018, the Company adopted ASU 2014-09 and all subsequent ASUs that modified ASC 606. While only a portion of the Company's revenues is impacted by this guidance as it does not apply to contracts falling under the leasing standard, as part of the implementation process the Company performed an analysis to identify accounting policies that needed to change and additional disclosures that are required. The Company considered factors such as customer contracts with unique revenue recognition considerations, the nature and type of goods and services offered, the degree to which contracts include multiple performance obligations or variable consideration, and the pattern in which revenue is currently recognized, among other things. All revenue streams applicable to the new standard (Spare parts and equipment sales and Managed services which is reflected within Other revenue) were evaluated by management. The Company considered recognition under the new standard and concluded the timing of the Company's revenue recognition will remain the same. The Company has also evaluated the changes in controls and processes that are necessary to implement the new standard, and no material changes were required.

Table of Contents

The following table disaggregates revenue by major source for the three and nine months ended September 30, 2018 (in thousands):

Three months ended September 30, 2018	Leasing and		Eliminations (1)	Total
	Related Operations	Spare Parts Sales		
Leasing revenue (2)	\$ 67,240	\$ —	\$ —	\$ 67,240
Gain on sale of leased equipment (3)	1,150	106	—	1,256
Spare parts and equipment sales	—	8,354	—	8,354
Managed services	1,124	—	—	1,124
Other revenue	—	274	(274)	—
Total revenue	\$ 69,514	\$ 8,734	\$ (274)	\$ 77,974

  

Nine months ended September 30, 2018	Leasing and		Eliminations (1)	Total
	Related Operations	Spare Parts Sales		
Leasing revenue (2)	\$ 188,984	\$ —	\$ —	\$ 188,984
Gain on sale of leased equipment (3)	1,917	225	—	2,142
Spare parts and equipment sales	—	21,701	—	21,701
Managed services	3,297	—	—	3,297
Other revenue	—	1,596	(1,550)	46
Total revenue	\$ 194,198	\$ 23,522	\$ (1,550)	\$ 216,170

(1) Represents revenue generated between our reportable segments.

(2) Leasing revenue is recognized under the lease accounting guidance in ASC 840 Leases, and therefore qualifies for the scope exception under ASC 606.

(3) Gain on sale of leased equipment is accounted for under ASC 610-20, Gains and losses from the derecognition of nonfinancial assets.

## Leasing revenue

Revenue from leasing of engines, aircraft and related parts and equipment is recognized as operating lease revenue on a straight-line basis over the terms of the applicable lease agreements. Revenue is not recognized when cash collection is not reasonably assured. When collectability is not reasonably assured, the customer is placed on non-accrual status and revenue is recognized when cash payments are received.

Under the terms of some of the Company's leases, the lessees pay use fees (also known as maintenance reserves) to the Company based on usage of the leased asset, which are designed to cover expected future maintenance costs. Some of these amounts are reimbursable to the lessee if they make specifically defined maintenance expenditures. Use fees

received are recognized in revenue as maintenance reserve revenue if they are not reimbursable to the lessee. Use fees that are reimbursable are recorded as a maintenance reserve liability until they are reimbursed to the lessee, the lease terminates, or the obligation to reimburse the lessee for such reserves ceases to exist, at which time they are recognized in revenue as maintenance reserve revenue.

Certain lessees may be significantly delinquent in their rental payments and may default on their lease obligations. As of September 30, 2018, the Company had an aggregate of approximately \$5.0 million in lease rent and \$2.1 million in maintenance reserve receivables more than 30 days past due. Inability to collect receivables or to repossess engines or other leased equipment in the event of a default by a lessee could have a material adverse effect on the Company. The Company estimates an allowance for doubtful accounts for lease receivables it does not consider fully collectible. The allowance for doubtful accounts includes the following: (1) specific reserves for receivables which are impaired for which management believes full collection is doubtful; and (2) a general reserve for estimated losses based on historical experience.

#### Gain on sale of leased equipment

The Company regularly sells equipment from its lease portfolio. This equipment may or may not be subject to a lease at the time of sale. The gain or loss on such sales is recognized as revenue and consists of proceeds associated with the sale less the net book value of the asset sold and any direct costs associated with the sale. To the extent that deposits associated with the engine are not included in the sale, any such amount is included in the calculation of gain or loss.

## Table of Contents

### Spare parts sales

The Spare Parts Sales reportable segment primarily engages in the sale of aircraft engine parts and materials through the acquisition or consignment of engines from third parties. The parts are sold at a fixed price with no right of return. In determining the performance obligation, management has identified the promise in the contract to be the shipment of the spare parts to the customer. Title passes to the buyer when the goods are shipped, and the buyer is responsible for any loss in transit, and the Company has a legal right to payment for the spare parts. Management has determined that physical acceptance of the spare parts to be a formality in accordance with ASC 606-10-5-86 and as the Company is not obliged to perform additional services under these arrangements, the shipment of the spare parts is the performance obligation.

The spare parts transaction price is a fixed dollar amount and is stated on each purchase order for a fixed amount by total number of parts. Spare parts revenue is based on a set price for a set number of parts as defined in the purchase order. The performance obligation is completed once the parts have shipped and, as a result, all of the transaction price is allocated to that performance obligation. Management has determined that it is appropriate for the Company to recognize spare parts sales at a point in time (i.e., the date the parts are shipped) under ASC 606. Additionally, there is no impact to the timing and amounts of revenue recognized for spare parts sales related to the implementation of ASC 606.

### Equipment Sales

Equipment sales represent the selective purchase and resale of commercial aircraft engines and other aircraft equipment. The Company and customer enter into an agreement which outlines the place and date of sale, purchase price, payment terms, condition of the asset, bill of sale, and the assignment of rights and warranties from the Company to the customer. Management has identified the promise in the equipment sale contract to be the transfer of ownership of the asset. Management believes the asset holds standalone value to the customer as it is not dependent on any other services for functionality purposes and therefore is distinct within the context of the contract and as described in ASC 606-10. As such, management has identified the transfer of the asset as the performance obligation. The transaction price is set at a fixed dollar amount per fixed quantity (number of assets) and is explicitly stated in each contract. Equipment sales revenue is based on a set price for a set number of assets, which is allocated to the performance obligation discussed above, in its entirety. The Company has determined the date of transfer to the customer to be the date the customer obtains control and title over the asset and the date which revenue is to be recognized and payment is due. As such, there is no impact to the timing and amounts of revenue recognized for equipment sales related to the implementation of ASC 606.

### Managed Services

Managed Services revenue predominantly represents fleet management and engine storage services which may be combined on a single contract with a customer. Fleet management services are performed for a stated fixed fee as agreed upon in the services agreement. Engine storage services are for a fixed monthly fee. For a contract containing more than one performance obligation, the allocation of the transaction price is generally performed on the basis of the relative stand-alone selling price of each distinct good or service in the contract. The result of allocation consideration on this basis is consistent with the overall core principal of ASC 606 (to recognize revenue in an amount that depicts the consideration to which the Company expects to be entitled in exchange for the promised goods or services). As each of the services provided within the contract have separate prices, the Company allocates the stated price to its related performance obligation described above. Management has determined each of the revenue elements contain performance obligations that are satisfied over time and therefore recognizes revenue over time in accordance with ASC 606-10-25-27. The Company will continue utilizing the percentage-of-completion method (input method) for recognizing Fleet Management services and will calculate revenues based on labor hours incurred. Additionally, as is required by ASC 606-10-25-35, as circumstances change over time, the Company will update its measure of progress to reflect any changes in the outcome of the performance obligation. Engine storage services will continue to be recognized on a monthly basis utilizing the input method of days passed. Therefore, there is no impact to the timing and amounts of revenue recognized for Managed Services related to the implementation of ASC 606.

Amounts owed for Managed services are typically billed upon contract completion. At January 1, 2018, \$0.4 million of unbilled revenue associated with outstanding contracts was reported in Other Assets, all of which was recognized by September 30, 2018. At September 30, 2018, unbilled revenue was \$0.8 million and the Company

Table of Contents

expects it to be fully recognized by March 31, 2019. Additionally, Managed services are presented within the Other revenue line in the condensed consolidated statements of income.

## 3. Investments

The Company is a partner with Mitsui & Co., Ltd. in a joint venture based in Dublin, Ireland — Willis Mitsui & Company Engine Support Limited (“WMES”) which acquires and leases jet engines. Each partner holds a fifty percent interest in the joint venture and the Company uses the equity method in recording investment activity. WMES owned a lease portfolio of 35 engines and one aircraft with a net book value of \$266.1 million as of September 30, 2018.

The Company is a partner with China Aviation Supplies Company Ltd. (“CASC”) in a joint venture named CASC Willis Engine Lease Company Limited (“CASC Willis”), which is based in Shanghai, China. The Company holds a fifty percent interest in the joint venture and uses the equity method in recording investment activity. CASC Willis acquires and leases jet engines to Chinese airlines and concentrates on the demand for leased commercial aircraft engines and aviation assets in the People’s Republic of China. CASC Willis owned a lease portfolio of four engines with a net book value of \$52.8 million as of September 30, 2018.

Nine Months Ended September 30, 2018	CASC		Total
	WMES	Willis	
	(in thousands)		
Investment in joint ventures as of December 31, 2017	\$ 36,014	\$ 14,627	\$ 50,641
Earnings (losses) from joint ventures	1,831	(262)	1,569
Deferred gain on engine sale	(1,280)	—	(1,280)
Distribution	(5,730)	—	(5,730)
Foreign currency translation adjustment	—	(762)	(762)
Investment in joint ventures as of September 30, 2018	\$ 30,835	\$ 13,603	\$ 44,438

“Other revenue” on the Consolidated Statements of Income includes management fees earned of \$0.6 million and \$0.5 million during the three months ended September 30, 2018 and 2017, respectively, and \$1.8 million during the nine months ended September 30, 2018 and 2017, respectively. These fees related to the servicing of engines for the WMES lease portfolio. During the nine months ended September 30, 2018, the Company sold two engines to WMES for \$23.2 million. During the nine months ended September 30, 2017, the Company sold two engines to WMES for \$14.8 million.

There were no engine sales to CASC Willis during the nine months ended September 30, 2018. During the nine months ended September 30, 2017, the Company sold one engine to CASC Willis for \$11.2 million.

Summarized financial information for 100% of WMES is presented in the following tables:

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2018	2017	2018	2017
	(in thousands)		(in thousands)	
Revenue	\$ 9,987	\$ 12,286	\$ 26,633	\$ 32,146
Expenses	8,408	6,366	22,762	20,820
WMES income before income taxes	\$ 1,579	\$ 5,920	\$ 3,871	\$ 11,326
				December
			September 30,	31,
			2018	2017
			(in thousands)	
Total assets			\$ 284,988	\$ 246,309
Total liabilities			211,981	165,228
Total WMES net equity			\$ 73,007	\$ 81,081

Table of Contents

## 4. Debt Obligations

Debt obligations consisted of the following:

	September 30, 2018	December 31, 2017
	(in thousands)	
Credit facility at a floating rate of interest of one-month LIBOR plus 2.0% at September 30, 2018, secured by engines. The facility has a committed amount of \$890.0 million at September 30, 2018, which revolves until the maturity date of April 2021	\$ 466,000	\$ 491,000
WEST IV Series A 2018 term notes payable at a fixed rate of interest of 4.75%, maturing in September 2043, secured by engines	326,759	—
WEST IV Series B 2018 term notes payable at a fixed rate of interest of 5.44%, maturing in September 2043, secured by engines	46,680	—
WEST III Series A 2017 term notes payable at a fixed rate of interest of 4.69%, maturing in August 2042, secured by engines	279,382	289,295
WEST III Series B 2017 term notes payable at a fixed rate of interest of 6.36%, maturing in August 2042, secured by engines	39,953	41,370
WEST II Series A 2012 term notes payable at a fixed rate of interest of 5.50%, maturing in September 2037, secured by engines	243,221	259,022
Note payable at fixed interest rates ranging from 2.60% to 2.97%, maturing in July 2024, secured by an aircraft	11,388	12,720
Note payable at a variable interest rate of one-month LIBOR plus 2.25%, matured in January 2018, secured by engines	—	10,336
	1,413,383	1,103,743
Less: unamortized debt issuance costs	(21,270)	(18,338)
Total debt obligations	\$ 1,392,113	\$ 1,085,405

Principal outstanding at September 30, 2018, is repayable as follows:

Year	(in thousands)
2018	\$ 13,812
2019	55,380
2020	54,980
2021 (includes \$466.0 million outstanding on revolving credit facility)	521,217
2022 (includes \$173.8 million outstanding on WEST II Series A 2012 term notes)	207,733
Thereafter	560,261
Total	\$ 1,413,383

On August 22, 2018, Willis Engine Structured Trust IV (“WEST IV”), a direct, wholly-owned subsidiary of the Company closed its offering of \$373.4 million in aggregate principal amount of fixed rate notes (the “WEST IV Notes”). The WEST IV Notes were issued in two series, with the Series A Notes issued in an aggregate principal amount of \$326.8 million and the Series B Notes in an aggregate principal amount of \$46.7 million. The WEST IV Notes are secured by, among other things, WEST IV’s direct and indirect interests in a portfolio of 55 engines and one airframe.

The Series A Notes have a fixed coupon of 4.75%, an expected maturity of approximately eight years and a final maturity date of September 15, 2043. The Series B Notes have a fixed coupon of 5.44%, an expected maturity of approximately eight years and a final maturity date of September 15, 2043. The Series A Notes were issued at a price of 99.99504% of par and the Series B Notes were issued at a price of 99.99853% of par. Principal and interest on the WEST IV Notes are payable monthly to the extent of available cash in accordance with a priority of payments included in the Indenture. Proceeds from asset sales by WEST IV will be used, at WEST IV’s election subject to certain conditions, to reduce WEST IV’s debt or to acquire other engines or airframes.

As of September 30, 2018, \$373.4 million of the WEST IV Notes were outstanding. The assets of WEST IV are not available to satisfy the Company’s obligations other than the obligations specific to WEST IV. WEST IV is

## Table of Contents

consolidated for financial statement presentation purposes. WEST IV's ability to make distributions and pay dividends to the Company is subject to the prior payments of its debt and other obligations and WEST IV's maintenance of adequate reserves and capital. Under WEST IV, cash is collected in a restricted account, which is used to service the debt and any remaining amounts, after debt service and defined expenses, are distributed to the Company. Additionally, a portion of the maintenance reserve payments and lease security deposits are formulaically accumulated in restricted accounts and are available to fund future maintenance events and to secure lease payments, respectively.

The Company maintains a revolving credit facility to finance the acquisition of aircraft engines for lease as well as for general working capital purposes. The \$890 million revolving credit facility has an accordion feature which would expand the entire credit facility up to \$1 billion. The interest rate is adjusted quarterly, based on the Company's leverage ratio, as calculated under the terms of the revolving credit facility.

Virtually all of the above debt requires ongoing compliance with the covenants of each financing, including debt/equity ratios, minimum tangible net worth and minimum interest coverage ratios, and other eligibility criteria including customer and geographic concentration restrictions. The Company also has certain negative financial covenants such as liens, advances, change in business, sales of assets, dividends and stock repurchases. These covenants are tested either monthly or quarterly and the Company was in full compliance with all financial covenant requirements at September 30, 2018.

## 5. Derivative Instruments

The Company periodically holds interest rate derivative instruments to mitigate exposure to changes in interest rates, in particular one-month LIBOR, with \$466.0 million and \$501.3 million of borrowings at September 30, 2018 and December 31, 2017, respectively, at variable rates. As a matter of policy, management does not use derivatives for speculative purposes. During 2016, the Company entered into one interest rate swap agreement which has a notional outstanding amount of \$100.0 million, with a remaining term of 31 months as of September 30, 2018. The fair value of the swap at September 30, 2018 and December 31, 2017 was \$2.8 million and \$1.1 million, respectively, representing a net asset. The Company recorded a gain of \$0.1 million and a loss of \$0.1 million in the three months ended September 30, 2018 and 2017, respectively, and a gain of \$0.2 million and a loss of \$0.5 million during the nine months ended September 30, 2018 and 2017, respectively, from derivative instruments.

The Company estimates the fair value of derivative instruments using a discounted cash flow technique and has used creditworthiness inputs that corroborate observable market data evaluating the Company's and counterparty's risk of non-performance. Valuation of the derivative instruments requires certain assumptions for underlying variables and the use of different assumptions would result in a different valuation. Management believes it has applied assumptions consistently during the period. The Company applies hedge accounting and accounts for the change in fair value of its cash flow hedges through other comprehensive income for all derivative instruments.



Table of Contents

## Effect of Derivative Instruments on Earnings in the Statements of Income and on Comprehensive Income

The following tables provide additional information about the financial statement effects related to the cash flow hedges for the three and nine months ended September 30, 2018 and 2017:

Derivatives in Cash Flow Hedging Relationships	Amount of Gain Recognized in OCI on Derivatives (Effective Portion) Three Months Ended		Location of Gain (Loss) Reclassified from Accumulated OCI into Income (Effective Portion)	Amount of Gain (Loss) Recognized from Accumulated OCI into Income (Effective Portion) Three Months Ended	
	September 30, 2018	2017		September 30, 2018	2017
Interest rate contracts	\$ 221	\$ 164	Interest expense	\$ 113	\$ (117)
Total	\$ 221	\$ 164	Total	\$ 113	\$ (117)

Derivatives in Cash Flow Hedging Relationships	Amount of Gain Recognized in OCI on Derivatives (Effective Portion) Nine Months Ended		Location of Gain (Loss) Reclassified from Accumulated OCI into Income (Effective Portion)	Amount of Gain (Loss) Recognized from Accumulated OCI into Income (Effective Portion) Nine Months Ended	
	September 30, 2018	2017		September 30, 2018	2017
Interest rate contracts	\$ 1,636	\$ 160	Interest expense	\$ 182	\$ (517)
Total	\$ 1,636	\$ 160	Total	\$ 182	\$ (517)

The derivatives were designated in a cash flow hedging relationship with the effective portion of the change in fair value of the derivative reported in the cash flow hedges subaccount of accumulated other comprehensive income.

The effective portion of the change in fair value on a derivative instrument designated as a cash flow hedge is reported as a component of other comprehensive income and is reclassified into earnings in the period during which the transaction being hedged affects earnings or it is probable that the forecasted transaction will not occur. The ineffective portion of the hedges is recorded in earnings in the current period. However, these are highly effective hedges and no significant ineffectiveness occurred in the periods presented.

## Counterparty Credit Risk

The Company evaluates the creditworthiness of the counterparties under its hedging agreements. The counterparty for the interest rate swap was a large financial institution in the United States that possessed an investment grade credit rating. Based on this rating, the Company believes that the counterparty was creditworthy and that their continuing performance under the hedging agreement was probable, and did not require the counterparty to provide collateral or other security to the Company.

## 6. Income Taxes

Income tax expense for the three and nine months ended September 30, 2018 was \$3.6 million and \$9.4 million, respectively. Income tax expense for the three and nine months ended September 30, 2017 was \$3.0 million and \$13.4 million, respectively. The effective tax rate for the three and nine months ended September 30, 2018 was 27.0% and 27.1%, respectively. The effective tax rate for the three and nine months ended September 30, 2017 was 35.9% and 40.7%, respectively. The 2018 tax rate reflects the enactment of the Tax Cuts and Jobs Act of 2017 (the "Act") which made significant changes to the Internal Revenue Code. Changes include, but are not limited to, a corporate tax rate decrease from 35% to 21% effective for tax years beginning after December 31, 2017.

The Company records tax expense or benefit for unusual or infrequent items discretely in the period in which they occur. The Company's tax rate is subject to change based on changes in the mix of assets leased to domestic and foreign lessees, the proportions of revenue generated within and outside of California, the amount of executive compensation exceeding \$1.0 million as defined in IRS code 162(m) and numerous other factors, including changes in tax law.

Table of Contents

7. Fair Value Measurements

The fair value of a financial instrument represents the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced sale or liquidation. Fair value estimates are made at a specific point in time, based on relevant market information about the financial instrument. These estimates are subjective in nature and involve uncertainties and matters of judgment, and therefore cannot be determined with precision.

Accounting standards define fair value as the price that would be received from selling an asset or paid to transfer a liability in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants at the measurement date. Accounting standards establish a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value and also establishes the following three levels of inputs that may be used to measure fair value:

Level 1 - Quoted prices in active markets for identical assets or liabilities.

Level 2 - Inputs other than Level 1 that are observable, either directly or indirectly, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3 - Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

The following methods and assumptions were used by the Company in estimating fair value disclosures for financial instruments:

- Cash and cash equivalents, restricted cash, operating lease related receivables, and accounts payable: The amounts reported in the accompanying Consolidated Balance Sheets approximate fair value due to their short-term nature.
- Debt obligations: The carrying amount of the Company's outstanding balance on its Debt obligations as of September 30, 2018 and December 31, 2017 was estimated to have a fair value of approximately \$1,416.6 million and \$1,090.0 million, respectively, based on the fair value of estimated future payments calculated using interest rates that approximate prevailing market rates at each period end (Level 2 inputs).

Assets Measured and Recorded at Fair Value on a Recurring Basis

As of September 30, 2018 and December 31, 2017, the Company measured the fair value of its interest rate swap of \$100.0 million (notional amount) based on Level 2 inputs, due to the usage of inputs that can be corroborated by observable market data. The Company estimates the fair value of derivative instruments using a discounted cash flow technique and has used creditworthiness inputs that corroborate observable market data evaluating the Company's and counterparties' risk of non-performance. The interest rate swap agreement had a net fair value of \$2.8 million and \$1.1 million as of September 30, 2018 and December 31, 2017, respectively. For the nine months ended September 30, 2018, \$0.2 million was realized through the income statement as a decrease in interest expense. For the nine months ended September 30, 2017, \$0.5 million was realized through the income statement as an increase in interest expense.

Assets Measured and Recorded at Fair Value on a Nonrecurring Basis

The Company determines fair value of long-lived assets held and used, such as Equipment held for operating lease and Equipment held for sale, by reference to independent appraisals, quoted market prices (e.g. an offer to purchase) and other factors. An impairment charge is recorded when the carrying value of the asset exceeds its fair

Table of Contents

value. The Company used Level 2 inputs to measure write-downs of equipment held for lease, equipment held for sale and spare parts inventory as of September 30, 2018 and December 31, 2017.

	Assets Written Down to Fair Value								Total Losses	
	September 30, 2018				December 31, 2017				Nine Months Ended	
	Level 1	Level 2	Level 3	Total	Level 1	Level 2	Level 3	Total	2018	2017
	(in thousands)								(in thousands)	
Equipment held for lease	\$ —	\$ 5,619	\$ —	\$ 5,619	\$ —	\$ 23,255	\$ —	\$ 23,255	\$ (3,434)	\$ (9,019)
Equipment held for sale	—	2,110	—	2,110	—	39,261	—	39,261	(1,359)	(10,649)
Spare parts inventory	—	934	—	934	—	5,336	—	5,336	(2,169)	(2,575)
Total	\$ —	\$ 8,663	\$ —	\$ 8,663	\$ —	\$ 67,852	\$ —	\$ 67,852	\$ (6,962)	\$ (22,243)

A write-down of \$4.8 million was recorded during the nine months ended September 30, 2018 for four engines and six airframe parts packages. The engines were written down due to a management decision to part-out the engines, in which the net book values exceeded the estimated proceeds. The airframe parts packages were held for consignment sales with third party vendors, in which the net book values exceeded the estimated proceeds.

A write-down of \$19.7 million was recorded during the nine months ended September 30, 2017 for seven engines and three aircraft for which their leases ended or were modified in the period. Management evaluated the equipment return condition, end of lease compensation, accumulated maintenance reserves and expected future proceeds from part out and sale to record its initial best estimate of impairment.

## 8. Earnings Per Share

Basic earnings per common share is computed by dividing net income, less preferred stock dividends and accretion of preferred stock issuance costs, by the weighted average number of common shares outstanding for the period. Treasury stock is excluded from the weighted average number of shares of common stock outstanding. Diluted earnings per share attributable to common stockholders is computed based on the weighted average number of shares of common stock and dilutive securities outstanding during the period. Dilutive securities are common stock equivalents that are freely exercisable into common stock at less than market prices or otherwise dilute earnings if converted. The net effect of common stock equivalents is based on the incremental common stock that would be issued upon the vesting of restricted stock using the treasury stock method. Common stock equivalents are not

included in diluted earnings per share when their inclusion is antidilutive. Additionally, redeemable preferred stock is not convertible and does not affect dilutive shares.

There were no anti-dilutive shares during the three months ended September 30, 2018 or 2017. There were 0.2 million and 925 anti-dilutive shares excluded from the computation of diluted weighted average earnings per common share during the nine months ended September 30, 2018 and 2017, respectively. The difference between average common shares outstanding to calculate basic and assuming full dilution is due to restricted stock issued under the 2007 Stock Incentive Plan.

The following table presents the calculation of basic and diluted EPS:

	Three Months Ended		Nine Months Ended	
	September 30, 2018	2017	September 30, 2018	2017
	(in thousands)		(in thousands)	
Net income attributable to common shareholders	\$ 8,834	\$ 4,939	\$ 22,624	\$ 18,436
Basic weighted average common shares outstanding	5,900	6,055	5,960	6,068
Potentially dilutive common shares	104	129	123	147
Diluted weighted average common shares outstanding	6,004	6,184	6,083	6,215
Basic weighted average earnings per common share	\$ 1.50	\$ 0.82	\$ 3.80	\$ 3.04
Diluted weighted average earnings per common share	\$ 1.47	\$ 0.80	\$ 3.72	\$ 2.97

Table of Contents

## 9. Equity

## Common Stock Repurchase

In September 2012, the Company announced that its Board of Directors authorized a plan to repurchase up to \$100.0 million of its common stock over the next 5 years. The Board of Directors reaffirmed the repurchase plan in October 2016 and extended the plan to December 31, 2018. Repurchased shares are immediately retired. During the nine months ended September 30, 2018, the Company repurchased a total of 423,629 shares of common stock for approximately \$14.5 million under this program, at a weighted average price of \$34.27 per share. At September 30, 2018, approximately \$14.8 million is available to purchase shares under the plan.

## Redeemable Preferred Stock

Dividends: The Company's Series A-1 Preferred Stock and Series A-2 Preferred Stock accrue quarterly dividends at the rate per annum of 6.5% per share. During the nine months ended September 30, 2018, the Company paid total dividends of \$2.4 million on the Series A-1 and Series A-2 Preferred Stock. For additional disclosures on the Company's Redeemable Preferred Stock, refer to Note 10 in the 2017 Form 10-K.

## 10. Stock-Based Compensation Plans

The components of stock-based compensation expense for the three and nine months ended September 30, 2018 and 2017 were as follows:

	Three months ended September 30, 2018		Nine months ended September 30, 2017	
	2018	2017	2018	2017
	(in thousands)		(in thousands)	
2007 Stock Incentive Plan	\$ 1,392	\$ 1,134	\$ 3,957	\$ 3,193
Employee Stock Purchase Plan	27	20	47	35
Total Stock Compensation Expense	\$ 1,419	\$ 1,154	\$ 4,004	\$ 3,228

The 2007 Stock Incentive Plan (the "2007 Plan") was adopted on May 24, 2007. Under this 2007 Plan, a total of 2,800,000 shares are authorized for stock based compensation available in the form of either restricted stock awards

(“RSA’s”) or stock options. The RSA’s are subject to service-based vesting, typically between one and four years, where a specific period of continued employment must pass before an award vests. The expense associated with these awards is recognized on a straight-line basis over the respective vesting period, with forfeitures accounted for as they occur. For any vesting tranche of an award, the cumulative amount of compensation cost recognized is equal to the portion of the grant date fair value of the award tranche that is actually vested at that date. There are no stock options outstanding under the 2007 Plan.

The 2018 Stock Incentive Plan (the “2018 Plan”) was adopted on May 24, 2018. Under this 2018 Plan, a total of 800,000 shares are authorized for stock based compensation, plus the number of shares remaining under the 2007 Plan and any future forfeited awards under the 2007 Plan, in the form of RSA’s. The RSA’s are subject to service-based vesting, typically between one and four years, where a specific period of continued employment must pass before an award vests. The expense associated with these awards is recognized on a straight-line basis over the respective vesting period, with forfeitures accounted for as they occur. For any vesting tranche of an award, the cumulative amount of compensation cost recognized is equal to the portion of the grant date fair value of the award tranche that is actually vested at that date.

As of September 30, 2018, the Company has granted 2,883,414 RSA’s under the 2007 Plan. Of this amount, 169,144 shares were cancelled and returned to the pool of shares which could be granted under the 2018 Plan resulting in a net number of 885,730 shares available for future issuance. The fair value of the restricted stock awards equaled the stock price at the grant date.

As of September 30, 2018, the Company has not granted RSA’s under the 2018 Plan.

Table of Contents

The following table summarizes restricted stock activity during the nine months ended September 30, 2018:

	Shares
Restricted stock at December 31, 2017	328,122
Shares granted	267,454
Shares forfeited	(2,400)
Shares vested	(167,870)
Restricted stock at September 30, 2018	425,306

Under the Employee Stock Purchase Plan (“ESPP”), as amended and restated effective April 1, 2018, 325,000 shares of common stock have been reserved for issuance. Eligible employees may designate not more than 10% of their cash compensation to be deducted each pay period for the purchase of common stock under the Purchase Plan. Participants may purchase not more than 1,000 shares or \$25,000 of common stock in any one calendar year. Each January 31 and July 31 shares of common stock are purchased with the employees’ payroll deductions from the immediately preceding six months at a price per share of 85% of the lesser of the market price of the common stock on the purchase date or the market price of the common stock on the date of entry into an offering period. In the nine months of 2018 and 2017, respectively, 11,284 and 11,485 shares of common stock were issued under the ESPP. The Company issues new shares through its transfer agent upon employee stock purchase.

## 11. Reportable Segments

The Company has two reportable segments: (i) Leasing and Related Operations which involves acquiring and leasing, primarily pursuant to operating leases, commercial aircraft, aircraft engines and other aircraft equipment and the selective purchase and resale of commercial aircraft engines and other aircraft equipment and other related businesses and (ii) Spare Parts Sales which involves the purchase and resale of after-market engine and airframe parts, whole engines, engine modules and portable aircraft components.

The Company evaluates the performance of each of the segments based on profit or loss after general and administrative expenses. While the Company believes there are synergies between the two business segments, the segments are managed separately because each requires different business strategies.

During the second quarter of 2018, the Company moved certain sales of leased equipment to the Spare Parts Sales segment from the Leasing and Related Operations segment and had no change in the determination of operating segments. In accordance with ASC 280-10, the Company has restated prior period information presented below to reflect this change in composition of its reportable segments.

The following tables present a summary of the reportable segments (in thousands):

20

---

Table of Contents

Three months ended September 30, 2018	Leasing and		Eliminations	
	Related Operations	Spare Parts Sales	(1)	Total
Revenue:				
Lease rent revenue	\$ 46,984	\$ —	\$ —	\$ 46,984
Maintenance reserve revenue	19,370	—	—	19,370
Spare parts and equipment sales	—	8,354	—	8,354
Gain on sale of leased equipment	1,150	106	—	1,256
Other revenue	2,010	274	(274)	2,010
Total revenue	69,514	8,734	(274)	77,974
Expenses:				
Depreciation and amortization expense	19,771	90	—	19,861
Cost of spare parts and equipment sales	—	5,848	—	5,848
Write-down of equipment	1,215	—	—	1,215
General and administrative	17,003	1,121	—	18,124
Technical expense	2,290	—	—	2,290
Interest expense	17,885	—	—	17,885
Total expenses	58,164	7,059	—	65,223
Earnings from operations	\$ 11,350	\$ 1,675	\$ (274)	\$ 12,751

Nine months ended September 30, 2018	Leasing and		Eliminations	
	Related Operations	Spare Parts Sales	(1)	Total
Revenue:				
Lease rent revenue	\$ 129,710	\$ —	\$ —	\$ 129,710
Maintenance reserve revenue	56,855	—	—	56,855
Spare parts and equipment sales	—	21,701	—	21,701
Gain on sale of leased equipment	1,917	225	—	2,142
Other revenue	5,716	1,596	(1,550)	5,762
Total revenue	194,198	23,522	(1,550)	216,170
Expenses:				
Depreciation and amortization expense	55,336	264	—	55,600
Cost of spare parts and equipment sales	—	16,537	—	16,537
Write-down of equipment	4,793	—	—	4,793
General and administrative	47,181	3,336	—	50,517
Technical expense	9,199	—	—	9,199
Interest expense	46,617	—	—	46,617
Total expenses	163,126	20,137	—	183,263
Earnings from operations	\$ 31,072	\$ 3,385	\$ (1,550)	\$ 32,907

Three months ended September 30, 2017	Leasing and		Eliminations	
	Related Operations	Spare Parts Sales	(1)	Total

Edgar Filing: WILLIS LEASE FINANCE CORP - Form 10-Q

Revenue:				
Lease rent revenue	\$ 33,474	\$ —	\$ —	\$ 33,474
Maintenance reserve revenue	20,370	—	—	20,370
Spare parts and equipment sales	—	9,294	—	9,294
Gain on sale of leased equipment	22	152	—	174
Other revenue	2,538	247	(236)	2,549
Total revenue	56,404	9,693	(236)	65,861

Expenses:				
Depreciation and amortization expense	16,056	86	—	16,142
Cost of spare parts and equipment sales (2)	—	7,148	—	7,148
Write-down of equipment (2)	6,226	—	—	6,226
General and administrative	13,387	921	—	14,308
Technical expense	2,605	—	—	2,605
Interest expense	14,220	—	—	14,220
Total expenses	52,494	8,155	—	60,649
Earnings from operations	\$ 3,910	\$ 1,538	\$ (236)	\$ 5,212

Nine months ended September 30, 2017	Leasing and		Eliminations (1)	Total
	Related Operations	Spare Parts Sales		
Revenue:				
Lease rent revenue	\$ 95,045	\$ —	\$ —	\$ 95,045
Maintenance reserve revenue	64,212	—	—	64,212
Spare parts and equipment sales	19,300	21,973	—	41,273
Gain on sale of leased equipment	4,463	221	—	4,684
Other revenue	6,314	697	(572)	6,439
Total revenue	189,334	22,891	(572)	211,653
Expenses:				
Depreciation and amortization expense	48,526	260	—	48,786
Cost of spare parts and equipment sales (2)	14,623	17,498	—	32,121
Write-down of equipment (2)	19,668	—	—	19,668
General and administrative	38,008	2,566	—	40,574
Technical expense	7,345	—	—	7,345
Interest expense	36,398	—	—	36,398
Total expenses	164,568	20,324	—	184,892
Earnings from operations	\$ 24,766	\$ 2,567	\$ (572)	\$ 26,761

(1) Represents revenue generated between our operating segments.

(2) The amounts herein include reclassifications of scrap inventory write-offs and lower of cost or market write-downs that were previously presented within Write-down of equipment to the Costs of spare parts and equipment sales expense line item. The three and nine months ended September 30, 2017 were impacted by a reclassification of \$0.7 million and \$2.6 million, respectively, reflected as an increase to Cost of spare parts and equipment sales and a decrease to Write-down of equipment.

Table of Contents

	Leasing and Related Operations	Spare Parts Sales	Eliminations	Total
Total assets as of September 30, 2018	\$ 1,919,003	\$ 46,193	\$ —	\$ 1,965,196
Total assets as of December 31, 2017	\$ 1,556,406	\$ 47,025	\$ —	\$ 1,603,431

## 12. Related Party Transaction

During the third quarter of 2018, the Company's Chief Executive Officer utilized the WASI spare parts warehouse to temporarily store personal equipment and has reimbursed the Company \$450 as of September 30, 2018 for such usage.

On September 12, 2018, in a transaction approved by an independent committee of the Board of Directors, the Company purchased 88,000 shares of common stock directly from the Company's Chief Executive Officer. The agreed and paid price per share was \$34.2972, the volume weighted average price on September 12, 2018.

During the nine months of 2018, the Company accrued approximately \$44,000 of expenses payable to Mikchalk Lake, LLC, an entity in which our Chief Executive Officer retains an ownership interest. These expenses were for lodging and other business related services. These transactions were approved by the Board's independent Directors.

## Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion should be read in conjunction with the Unaudited Condensed Consolidated Financial Statements and notes thereto included under Part I, Item 1 of this Quarterly Report on Form 10-Q. In addition, reference should be made to our audited Consolidated Financial Statements and notes thereto and related "Management's Discussion and Analysis of Financial Condition and Results of Operations" included in our 2017 Annual Report on Form 10-K ("2017 Form 10-K"). In addition to historical consolidated financial information, the following discussion contains forward-looking statements that reflect our plans, estimates and beliefs. Our actual results may differ materially from those contained in or implied by any forward-looking statements. The financial information included in this discussion and in our consolidated financial statements may not be indicative of our consolidated financial position, operating results, changes in equity and cash flows in the future. See "Special Note Regarding

Forward-Looking Statements” included earlier in this report.

## Overview

Our core business is acquiring and leasing commercial aircraft and aircraft engines and related aircraft equipment pursuant to operating leases, and the selective sale of such aircraft, engines and related equipment, all of which we sometimes collectively refer to as “equipment.” As of September 30, 2018, all of our leases were operating leases. As of September 30, 2018, we had 101 lessees in 51 countries. Our portfolio is continually changing due to equipment acquisitions and sales. As of September 30, 2018, our lease portfolio consisted of 250 engines, 14 aircraft and 10 other leased parts and equipment with an aggregate net book value of \$1,590.5 million. As of September 30, 2018, we also managed 423 engines, aircraft and related equipment on behalf of other parties.

Our wholly owned subsidiary Willis Asset Management Limited (“Willis Asset Management”) is focused on the engine management and consulting business. Willis Aeronautical Services, Inc. (“Willis Aero”) is a wholly-owned subsidiary whose primary focus is the sale of aircraft engine parts and materials through the acquisition or consignment of aircraft and engines from third parties.

We actively manage our portfolio and structure our leases to maximize the residual values of our leased assets. Our leasing business focuses on popular Stage III commercial jet engines manufactured by CFMI, General Electric, Pratt & Whitney, Rolls Royce and International Aero Engines. These engines are the most widely used engines in the world, powering Airbus, Boeing, McDonnell Douglas, Bombardier and Embraer aircraft. Also, on a more limited basis, we lease aircraft that typically utilize the engines that are in our portfolio.

## Critical Accounting Policies and Estimates

There have been no material changes to our critical accounting policies and estimates from the information provided in Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations included in our 2017 Form 10-K.

Table of Contents

Results of Operations

Three months ended September 30, 2018 compared to the three months ended September 30, 2017:

**Lease Rent Revenue.** Lease rent revenue increased by \$13.5 million or 40.4% to \$47.0 million in the three months ended September 30, 2018 from \$33.5 million for the three months ended September 30, 2017. Lease rent revenue consists of rental income from long-term and short-term engine leases, aircraft leases, and other leased parts and equipment. The increase is primarily driven by an increase in lease rates and increased net book value of the leased assets. During the three months ended September 30, 2018, we purchased equipment (including capitalized costs) totaling \$77.1 million, which primarily consisted of eight engines purchased for our lease portfolio. During the three months ended September 30, 2017, we purchased equipment (including capitalized costs) totaling \$65.0 million, primarily consisting of two engines and five aircraft.

The aggregate net book value of equipment held for lease at September 30, 2018 and September 30, 2017, was \$1,590.5 million and \$1,199.9 million, respectively, an increase of 32.6%. Average utilization (based on net book value) for the three months ended September 30, 2018 decreased to approximately 90% from 91% for the three months ended September 30, 2017. Utilization was influenced by the Company's acquisition of new equipment.

**Maintenance Reserve Revenue.** Maintenance reserve revenue decreased \$1.0 million, or 4.9%, to \$19.4 million for the three months ended September 30, 2018 from \$20.4 million for the three months ended September 30, 2017. We recognized \$18.0 million maintenance reserve revenue on our short-term, non-reimbursable leases during the three months of 2018, compared to \$11.6 million in the prior year period.

During the three months ended September 30, 2018, two reimbursable leases terminated resulting in the recognition of \$1.4 million in maintenance reserve revenue. Comparatively, during the same three months of 2017, three reimbursable lease terminated resulting in the recognition of \$8.8 million in maintenance reserve revenue.

**Spare Parts and Equipment Sales.** Spare parts and equipment sales decreased by \$0.9 million, or 10.1%, to \$8.4 million for the three months ended September 30, 2018 compared to \$9.3 million for the three months ended September 30, 2017. There were no equipment sales in the third quarter of 2018 or 2017.

**Gain on Sale of Leased Equipment.** Gain on sale of leased equipment increased by \$1.1 million to \$1.3 million in the three months ended September 30, 2018 from \$0.2 million in the three months ended September 30, 2017. The \$1.3

million gain in the three months ended September 30, 2018 reflects the sale of two engines, one aircraft, one airframe and leased parts and equipment. The \$0.2 million gain in the three months ended September 30, 2017 reflects the sale of leased parts and equipment.

**Other Revenue.** Other revenue decreased by \$0.5 million, or 21.1%, to \$2.0 million in the three months ended September 30, 2018 from \$2.5 million in the three months ended September 30, 2017. Other revenue primarily reflects fees earned related to engines managed on behalf of third parties and service fee revenue.

**Depreciation and Amortization Expense.** Depreciation and amortization expense increased by \$3.7 million, or 23.0%, to \$19.9 million for the three months ended September 30, 2018 compared to \$16.1 million for the three months ended September 30, 2017. The increase reflects the larger net book value of the lease portfolio, and the change in mix of portfolio, as compared to the prior year period.

**Cost of Spare Parts and Equipment Sales.** Cost of spare parts and equipment sales decreased by \$1.3 million, or 18.2%, to \$5.8 million for the three months ended September 30, 2018 compared to \$7.1 million for the three months ended September 30, 2017. The decrease in the cost of spare parts sales is directly correlated to the decrease in spare parts sales. Cost of spare parts sales for the three months ended September 30, 2017 include \$0.7 million of reclassifications of scrap inventory write-offs and lower of cost or market write-downs that were previously presented within the Write-down of equipment expense line item. The reclassification is reflected as an increase to Cost of spare parts and equipment sales and a decrease to Write-down of equipment.

There were no costs of equipment sales in the third quarter of 2018 or 2017.

Table of Contents

**Write-down of Equipment.** Write-down of equipment decreased by \$5.0 million, or 80.5%, to \$1.2 million for the three months ended September 30, 2018 compared to \$6.2 million for the three months ended September 30, 2017. During the three months ended September 30, 2018, we wrote down one engine and six airframe parts packages, compared to two engines and six airframe parts packages in the three months ended September 30, 2017.

**General and Administrative Expenses.** General and administrative expenses increased by \$3.8 million, or 26.7%, to \$18.1 million for the three months ended September 30, 2018 compared to \$14.3 million for the three months ended September 30, 2017. The increase, when compared to the prior year period, primarily reflects additional expenses associated with the transition of personnel to our new Coconut Creek facility, other transition related expenses, and increased bonus accrual due to operating performance.

**Technical Expense.** Technical expense decreased by \$0.3 million, or 12.1%, to \$2.3 million for the three months ended September 30, 2018 compared to \$2.6 million for the three months ended September 30, 2017. Technical expense consists of the cost of engine repairs, engine thrust rental fees, outsourced technical support services, sublease engine rental expense, engine storage and freight costs. This decrease primarily reflects a decrease of \$0.7 million in engine maintenance costs, partly offset by an increase of \$0.4 million in engine freight and storage costs.

**Interest Expense.** Interest expense increased to \$17.9 million for the three months ended September 30, 2018 compared to \$14.2 million for the three months ended September 30, 2017. This increase is a result of higher debt obligation balances and increased borrowing cost in 2018 associated with our LIBOR based borrowings and our WEST III and WEST IV notes. Debt obligations outstanding, net of unamortized debt issuance costs, as of September 30, 2018 and 2017, were \$1,392.1 million and \$932.1 million, respectively, of which \$466.0 million and \$339.4, respectively, was tied to one-month LIBOR. As of September 30, 2018 and 2017, one-month LIBOR was 2.26% and 1.24%, respectively.

**Income Tax Expense.** Income tax expense was \$3.6 million for the three months ended September 30, 2018 compared to \$3.0 million for the three months ended September 30, 2017. The effective tax rate for the third quarter of 2018 was 27.0% compared to 35.9% in the prior year period. This decrease was predominantly due to the Tax Cuts and Jobs Act of 2017 (the "Act") that was signed into law making significant changes to the Internal Revenue Code, decreasing federal corporate tax rate from 35% to 21% for tax years beginning after December 31, 2017, lower forecasted permanent non-deductible expenses for executive compensation (IRS code 162(m) calculation) and changes in the proportions of revenue generated within and outside of California.

Nine months ended September 30, 2018 compared to the nine months ended September 30, 2017:

**Lease Rent Revenue.** Lease rent revenue increased by \$34.7 million or 36.5% to \$129.7 million in the nine months ended September 30, 2018 from \$95.0 million for the nine months ended September 30, 2017. The increase is

primarily driven by an increase in lease rates and increased net book value of the leased assets. During the nine months ended September 30, 2018, we purchased equipment (including capitalized costs) totaling \$320.2 million, which primarily included 37 engines purchased for our lease portfolio. During the nine months ended September 30, 2017, we purchased equipment (including capitalized costs) totaling \$177.3 million, which primarily included 16 engines and 13 aircraft.

The aggregate net book value of equipment held for lease at September 30, 2018 and September 30, 2017, was \$1,590.5 million and \$1,199.9 million, respectively, an increase of 32.6%. Average utilization (based on net book value) for the nine months ended September 30, 2018 decreased to approximately 88% from 89% for the nine months ended September 30, 2017. Utilization was influenced by the Company's acquisition of new equipment.

Maintenance Reserve Revenue. Maintenance reserve revenue decreased \$7.4 million, or 11.5%, to \$56.9 million for the nine months ended September 30, 2018 from \$64.2 million for the nine months ended September 30, 2017. We recognized \$44.8 million maintenance reserve revenue on our short-term, non-reimbursable leases during the nine months of 2018, compared to \$31.8 million in the prior year period.

During the nine months ended September 30, 2018, one lease modification and five reimbursable lease terminations resulted in the recognition of \$12.1 million in maintenance reserve revenue. Comparatively, during the same period of 2017, 10 reimbursable leases terminated resulting in the recognition of \$32.4 million in maintenance reserve revenue.

Table of Contents

**Spare Parts and Equipment Sales.** Spare parts and equipment sales decreased by \$19.6 million, or 47.4%, to \$21.7 million for the nine months ended September 30, 2018 compared to \$41.3 million for the nine months ended September 30, 2017. Spare parts sales for the nine months ended September 30, 2018 were \$21.7 million compared to \$22.0 million in the comparable period in 2017. There were no equipment sales for the nine months ended September 30, 2018, compared to the sale of five airframes for \$19.3 million in the prior year period.

**Gain on Sale of Leased Equipment.** Gain on sale of leased equipment decreased by \$2.5 million, or 54.3% to \$2.1 million in the nine months ended September 30, 2018 from \$4.7 million in the nine months ended September 30, 2017. During the nine months ended September 30, 2018 we sold five engines, three aircraft, one airframe and other related equipment for a net gain of \$2.1 million, compared to seven engines and other related equipment generating a net gain of \$4.7 million during the nine months ended September 30, 2017.

**Other Revenue.** Other revenue decreased by \$0.7 million, or 10.5%, to \$5.8 million in the nine months ended September 30, 2018 from \$6.4 million in the nine months ended September 30, 2017.

**Depreciation and Amortization Expense.** Depreciation and amortization expense increased by \$6.8 million, or 14.0%, to \$55.6 million for the nine months ended September 30, 2018 compared to \$48.8 million for the nine months ended September 30, 2017. The increase reflects the larger net book value of the lease portfolio, and the change in mix of portfolio, as compared to the prior year period.

**Cost of Spare Parts and Equipment Sales.** Cost of spare parts and equipment sales decreased by \$15.6 million, or 48.5%, to \$16.5 million for the nine months ended September 30, 2018 compared to \$32.1 million for the nine months ended September 30, 2017. The decrease in the cost of spare parts sales is directly correlated to the decrease in spare parts sales. Cost of spare parts sales for the nine months ended September 30, 2017 include \$2.6 million of reclassifications of scrap inventory write-offs and lower of cost or market write-downs that were previously presented within the Write-down of equipment expense line item. The reclassification is reflected as an increase to Cost of spare parts and equipment sales and a decrease to Write-down of equipment.

There were no costs of equipment sales for the nine months ended September 30, 2018, compared to \$14.6 million in the prior year period.

**Write-down of Equipment.** Write-down of equipment decreased by \$14.9 million, or 75.6%, to \$4.8 million for the nine months ended September 30, 2018 compared to \$19.7 million for the nine months ended September 30, 2017. The \$4.8 million for the nine months ended September 30, 2018 reflects the write-down of four engines and six airframe parts packages. A write-down of equipment totaling \$19.7 million was recorded in the nine months ended September 30, 2017 due to a management decision to consign four engines for part-out and sale, in which the asset's net book value exceeded the estimated proceeds. A further write-down of \$3.0 million was recorded due to the

adjustment of the carrying value for four engines within the portfolio to reflect estimated market value.

**General and Administrative Expenses.** General and administrative expenses increased by \$9.9 million, or 24.5%, to \$50.5 million for the nine months ended September 30, 2018 compared to \$40.6 million for the nine months ended September 30, 2017. The increase, when compared to the prior year period, primarily reflects additional expenses associated with the transition of personnel to our new Coconut Creek facility, other transition related expenses, and increased bonus accrual due to operating performance.

**Technical Expense.** Technical expense increased by \$1.9 million, or 25.2%, to \$9.2 million for the nine months ended September 30, 2018 compared to \$7.3 million for the nine months ended September 30, 2017. This increase primarily reflects an increase of \$1.3 million in engine maintenance costs.

**Interest Expense.** Interest expense increased to \$46.6 million for the nine months ended September 30, 2018 compared to \$36.4 million for the nine months ended September 30, 2017. This increase is a result of higher debt obligation balances and increased borrowing cost in 2018 associated with our LIBOR based borrowings and our WEST III and WEST IV notes.

**Income Tax Expense.** Income tax expense was \$9.4 million for the nine months ended September 30, 2018 compared to \$13.4 million for the nine months ended September 30, 2017. The effective tax rate for the first nine months of 2018 was 27.1% compared to 40.7% in the prior year period. This decrease was predominantly due to the Tax Cuts and Jobs Act of 2017 (the "Act") that was signed into law making significant changes to the Internal Revenue

## Table of Contents

Code, decreasing federal corporate tax rate from 35% to 21% for tax years beginning after December 31, 2017, the effect of lower forecasted permanent non-deductible expenses for executive compensation (IRS code 162(m) calculation) and changes in the proportions of revenue generated within and outside of California.

## Financial Position, Liquidity and Capital Resources

At September 30, 2018, the Company had \$163.9 million of cash, cash equivalents and restricted cash. We finance our growth through borrowings secured by our equipment lease portfolio. Cash of approximately \$616.4 million and \$485.7 million in the nine months ended September 30, 2018 and 2017, respectively, was derived from this activity. In these same time periods, \$306.8 million and \$448.2 million, respectively, was used to pay down related debt.

## Cash Flows Discussion

Cash flows provided by operating activities was \$100.8 million and \$112.0 million in the nine months ended September 30, 2018 and 2017, respectively. The decrease was primarily due to the increase in spare parts and equipment, partly offset by the change in maintenance reserves.

Cash flows from operations are driven significantly by payments made under our lease agreements, which comprise lease rent revenue, security deposits and maintenance reserves, and are offset by interest expense and general and administrative costs. Cash received from maintenance reserve arrangements and lease security deposits for some of our engines on lease are restricted per our debt agreements. The lease revenue stream, in the short-term, is at fixed rates while a portion of our debt is at variable rates. If interest rates increase, it is unlikely we could increase lease rates in the short term and this would cause a reduction in our earnings and operating cash flows. Lease rent revenue and maintenance reserves are also affected by the amount of equipment off-lease. Approximately 92% and 89%, by book value, of our lease assets were on lease at September 30, 2018 and December 31, 2017, respectively. The average utilization rate was approximately 88% and 89% for the nine months ended September 30, 2018 and 2017, respectively. The decline in percentage year over year is a direct result of purchases made in the nine months of 2018, a large portion of which were off-lease. If there is any increase in off-lease rates or deterioration in lease rates that are not offset by reductions in interest rates, there will be a negative impact on earnings and cash flows from operations.

Cash flows used in investing activities was \$270.0 million and \$123.9 million in the nine months ended September 30, 2018 and 2017, respectively. Our primary use of funds is for the purchase of equipment for operating lease. Purchases of equipment held for operating lease (including capitalized costs and prepaid deposits made in the period) totaled \$320.2 million and \$177.3 million for the nine months ended September 30, 2018 and 2017, respectively.

Cash flows provided by financing activities was \$285.7 million for the nine months ended September 30, 2018 and primarily reflected \$616.4 million in proceeds from the issuance of debt obligations, partly offset by \$306.8 million in principal payments and \$14.5 million in share repurchases. Cash flows provided by financing activities of \$51.4 million in the nine months ended September 30, 2017 primarily reflected \$485.7 million in proceeds from debt obligations, partly offset by \$448.2 million in principal payments.

#### Preferred Stock Dividends

The Company's Series A-1 Preferred Stock and Series A-2 Preferred Stock accrue quarterly dividends at the rate per annum of 6.5% per share. During the nine months ended September 30, 2018, the Company paid total dividends of \$2.4 million on the Series A-1 and Series A-2 Preferred Stock.

#### Debt Obligations and Covenant Compliance

On August 22, 2018, Willis Engine Structured Trust IV ("WEST IV"), a direct, wholly-owned subsidiary of the Company closed its offering of \$373.4 million in aggregate principal amount of fixed rate notes (the "WEST IV Notes"). The WEST IV Notes were issued in two series, with the Series A Notes issued in an aggregate principal amount of \$326.8 million and the Series B Notes in an aggregate principal amount of \$46.7 million. The WEST IV Notes are secured by, among other things, WEST IV's direct and indirect interests in a portfolio of 55 engines and one airframe.

The Series A Notes have a fixed coupon of 4.75%, an expected maturity of approximately eight years and a final maturity date of September 15, 2043 and Series B Notes will have a fixed coupon of 5.44%, an expected maturity of

Table of Contents

approximately eight years and a final maturity date of September 15, 2043. The Series A Notes were issued at a price of 99.99504% of par and the Series B Notes were issued at a price of 99.99853% of par. Principal and interest on the WEST IV Notes are payable monthly to the extent of available cash in accordance with a priority of payments included in the Indenture. Proceeds from asset sales by WEST IV will be used, at WEST IV's election subject to certain conditions, to reduce WEST IV's debt or to acquire other engines or airframes.

The assets of WEST IV are not available to satisfy our or our affiliates' obligations other than the obligations specific to WEST IV. WEST IV is consolidated for financial statement presentation purposes. WEST IV's ability to make distributions and pay dividends to the Company is subject to the prior payments of its debt and other obligations and WEST IV's maintenance of adequate reserves and capital. Under WEST IV, cash is collected in a restricted account, which is used to service the debt and any remaining amounts, after debt service and defined expenses, are distributed to the Company. Additionally, a portion of the maintenance reserve payments and lease security deposits are formulaically accumulated in restricted accounts and are available to fund future maintenance events and to secure lease payments, respectively.

At September 30, 2018, Debt obligations consist of loans totaling \$1,392.1 million, net of unamortized issuance costs, payable with interest rates varying between approximately 2.6% and 6.4%. Substantially all of our assets are pledged to secure our obligations to creditors. For further information on our debt instruments, see the "Debt Obligations" Note 4 in Part I, Item 1 of this Form 10-Q.

Virtually all of the Company's debt requires our ongoing compliance with the covenants of each financing, including debt/equity ratios, minimum tangible net worth and minimum interest coverage ratios, and other eligibility criteria including customer and geographic concentration restrictions. Under our revolving credit facility, we can borrow no more than 85% of an engine's net book value and 65% of an airframe's or spare parts inventory's net book value. Therefore we must have other available funds for the balance of the purchase price of any new equipment to be purchased or we will not be permitted to draw on our revolver. The facilities are also cross-defaulted against other facilities. If we do not comply with the covenants or eligibility requirements, we may not be permitted to borrow additional funds and accelerated payments may become necessary. Additionally, much of the debt is secured by engines and aircraft, and to the extent that engines or aircraft are sold, repayment of that portion of the debt could be required.

At September 30, 2018, we are in compliance with the covenants specified in our revolving credit facility, including the Interest Coverage Ratio requirement of at least 2.25 to 1.00, and the Total Leverage Ratio requirement to remain below 4.25 to 1.00. The Interest Coverage Ratio, as defined in the credit facility, is the ratio of: earnings before interest, taxes, depreciation and amortization (EBITDA) and other one-time charges to consolidated interest expense. The Total Leverage Ratio, as defined in the credit facility, is the ratio of total indebtedness to tangible net worth. At September 30, 2018, we are in compliance with the covenants specified in the WEST II, WEST III and WEST IV indentures, servicing and other debt related agreements.

## Contractual Obligations and Commitments

Repayments of our gross debt obligations primarily consist of scheduled installments due under term loans and are funded by the use of unrestricted cash reserves and from cash flows from ongoing operations. The table below summarizes our contractual commitments at September 30, 2018:

	Total	Payment due by period (in thousands)			More than 5 Years
		Less than 1 Year	1-3 Years	3-5 Years	
Debt obligations	\$ 1,413,383	\$ 55,547	\$ 576,044	\$ 247,029	\$ 534,763
Interest payments under debt obligations	339,157	68,305	118,458	65,581	86,813
Operating lease obligations	4,764	891	1,386	1,141	1,346
Purchase obligations	70,584	70,584	—	—	—
Total	\$ 1,827,888	\$ 195,327	\$ 695,888	\$ 313,751	\$ 622,922

We have estimated the interest payments due under debt obligations by applying the interest rates applicable at September 30, 2018 to the remaining debt, adjusted for the estimated debt repayments identified in the table above. Actual interest payments made will vary due to changes in the rates for one-month LIBOR.

## Table of Contents

We believe our equity base, internally generated funds and existing debt facilities are sufficient to maintain our level of operations through the next twelve months. However, a decline in the level of internally generated funds or an inability to obtain lease commitments for our off-lease engines (including new engines from manufacturers), would limit availability of funding under our existing debt facilities, and/or result in a significant step-up in borrowing costs. Such limits on availability of funding and increased borrowing costs would impair our ability to sustain our level of operations. We continue to discuss additions to our capital base with our commercial and investment banks. If we are not able to access additional capital, our ability to continue to grow our asset base consistent with historical trends could be constrained and our future growth limited to that which can be funded from internally generated capital.

For any interest rate swaps that we enter into, we will be exposed to risk in the event of non-performance of the interest rate hedge counter-parties. We anticipate that we may hedge additional amounts of our floating rate debt in the future.

## Recent Accounting Pronouncements

The most recent adopted accounting pronouncements and accounting pronouncements to be adopted by the Company are described in Note 1 to our unaudited consolidated financial statements included in this Quarterly Report on Form 10-Q.

## Item 3. Quantitative and Qualitative Disclosures about Market Risk

Our primary market risk exposure is that of interest rate risk. A change in LIBOR rates would affect our cost of borrowing. Increases in interest rates, which may cause us to raise the implicit rates charged to our customers, could result in a reduction in demand for our leases. Alternatively, we may price our leases based on market rates so as to keep the fleet on-lease and suffer a decrease in our operating margin due to interest costs that we are unable to pass on to our customers. As of September 30, 2018, \$466.0 million of our outstanding debt is variable rate debt. We estimate that for every one percent increase or decrease in interest rates on our variable rate debt, our annual interest expense would increase or decrease \$3.7 million.

We hedge a portion of our borrowings from time to time, effectively fixing the rate of these borrowings. This hedging activity helps protect us against reduced margins on longer term fixed rate leases. Such hedging activities may limit our ability to participate in the benefits of any decrease in interest rates, but may also protect us from increases in interest rates. Furthermore, since lease rates tend to vary with interest rate levels, it is possible that we can adjust lease rates for the effect of change in interest rates at the termination of leases. Other financial assets and liabilities are at fixed rates.

We are also exposed to currency devaluation risk. Most of our leases require payment in U.S. dollars. During the nine months ended September 30, 2018, 78% of our lease rent revenues came from non-United States domiciled lessees. If these lessees' currency devalues against the U.S. dollar, the lessees could potentially encounter difficulty in making their lease payments.

No customer accounted for more than 10% of total lease rent revenue during the nine months ended September 30, 2018 and 2017, respectively.

#### Item 4. Controls and Procedures

(a) Evaluation of disclosure controls and procedures. In accordance with Rule 13a-15b under the Securities Exchange Act of 1934, as amended (Exchange Act) we (with the participation of our Chief Executive Officer (CEO) and Chief Financial Officer (CFO)) carried out an evaluation of the effectiveness and design of our disclosure controls and procedures (as defined in Rules 13-15(e) and 15d-15(e) of the Exchange Act), as of the end of the period covered by this report. Based on such evaluation, our CEO and CFO have concluded that such disclosure controls and procedures, are effective to provide reasonable assurance that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in SEC rules and forms, and is accumulated and communicated to Company's management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

Table of Contents

(b) Inherent Limitations on Controls. Management, including the CEO and CFO, does not expect that our disclosure controls and procedures will prevent or detect all error and fraud. Any control system, no matter how well designed and operated, is based upon certain assumptions and can provide only reasonable, not absolute, assurance that its objectives will be met. Further, no evaluation of controls can provide absolute assurance that misstatements due to error or fraud will not occur or that all control issues and instances of fraud, if any, within the Company have been detected. The design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs.

(c) Changes in internal control over financial reporting. There has been no change in our internal controls over financial reporting during our fiscal quarter ended September 30, 2018 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II — OTHER INFORMATION

Item 1A. Risk Factors

Before making an investment decision, investors should carefully consider the risks in the “Risk Factors” in Part 1: Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2017 filed with the SEC on March 15, 2018. These risks are not the only ones facing the Company. Additional risks not currently known to us or that we currently believe are immaterial may also impair our business operations. Any of these risks could adversely affect our business, cash flows, financial condition and results of operations. The trading price of our common stock could fluctuate due to any of these risks, and investors may lose all or part of their investment. In assessing these risks, investors should also refer to the other information contained or incorporated by reference in this Quarterly Report on Form 10-Q. Except as described below, there have been no material changes in our risk factors from those discussed in our Annual Report on Form 10-K for the year ended December 31, 2017.

Changes to trade policy, tariff, sanction and import/export regulations may have a material adverse effect on our business, financial condition and results of operations.

Changes in U.S. or international, political, regulatory and economic conditions or in laws and policies governing foreign trade and investment in the territories or countries where we currently conduct our business, could adversely affect our business. The executive branch of the United States government has instituted or proposed changes in trade policies that include the negotiation or termination of trade agreements, the imposition of higher tariffs on imports into the U.S., economic sanctions on corporations or countries, and other government regulations affecting trade between the U.S. and other countries that will affect the manner in which we conduct our business. Trading partners of the United States have also implemented and threatened to implement retaliatory tariffs and/or other impediments to trade.

As a result of new or threatened tariffs, sanctions and/or impediments to trade, both from the United States and other countries, there may be greater restrictions and economic disincentives on international trade. The new or threatened tariffs, sanctions and other changes in trade policy could trigger retaliatory actions by affected countries, and certain foreign governments have instituted or are considering imposing tariffs and/or economic sanctions on certain U.S. goods. We do a significant amount of business that would be impacted by changes to the trade policies of the U.S. and foreign countries (including governmental action related to tariffs, international trade agreements, or economic sanctions). Such changes have the potential to adversely impact the U.S. economy or certain sectors thereof, our industry and the global demand for our products and services, and as a result, could have an adverse effect on our business, financial condition and results of operations.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

(a) None.

(b) None.

(c) Issuer Purchases of Equity Securities. In September 2012, the Company announced that its Board of Directors authorized a plan to repurchase up to \$100.0 million of its common stock over the next 5 years. The Board of Directors reaffirmed the repurchase plan in October 2016 and extended the plan to December 31, 2018.

Table of Contents

Common stock repurchases, under our authorized plan, in the three months ended September 30, 2018 were as follows:

Period	Total Number of Shares Purchased (in thousands,	Average Price per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans	Approximate Dollar Value of Shares that May Yet be Purchased Under the Plans
July 2018	—	\$ —	—	\$ 19,157
August 2018	10,468	\$ 34.15	10,468	\$ 18,800
September 2018	115,794	\$ 34.34	115,794	\$ 14,823
Total	126,262	\$ 34.33	126,262	\$ 14,823

## Item 5. Other Information

None.

30

---

Table of Contents

Item 6.

EXHIBITS

Exhibit Number	Description
10.34*	<u>Administrative Agency Agreement dated as of August 22, 2018 among Willis Engine Structured Trust IV, the Registrant, Deutsche Bank Trust Company Americas, as trustee, and each Managed Group Member referred to therein and from time to time made a party thereto.</u>
10.35*	<u>Asset Purchase Agreement dated as of August 22, 2018 between the Registrant and Willis Engine Structured Trust IV.</u>
10.36*	<u>Trust Indenture dated as of August 22, 2018 among Willis Engine Structured Trust IV, Deutsche Bank Trust Company Americas, as Trustee, the Registrant and Bank of America, N.A.</u>
10.37*	<u>Revolving Credit Agreement dated as of August 22, 2018 among Willis Engine Structured Trust IV, Bank of America, N.A. and the Registrant.</u>
10.38*	<u>Servicing Agreement dated as of August 22, 2018 among Willis Engine Structured Trust IV, the Registrant and each Service Group Member referred to therein and from time to time made a party thereto.</u>
10.39*	<u>Security Trust Agreement dated as of August 22, 2018 among Willis Engine Structured Trust IV, each Grantor referred to therein and from time to time made a party thereto and Deutsche Bank Trust Company Americas, as security trustee and operating bank.</u>
10.40*	<u>Amendment No. 1 to Agreement to Purchase Spare Engines, dated July 25, 2018, between IAE International Aero Engines AG and Willis Lease Finance Corporation.</u>
10.41*	<u>Amendment No. 2 to Agreement to Purchase Spare Engines, dated August 9, 2018, between IAE International Aero Engines AG and Willis Lease Finance Corporation.</u>
31.1	<u>Certification of Charles F. Willis, IV, pursuant to Section 1350 as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u>
31.2	<u>Certification of Scott B. Flaherty, pursuant to Section 1350 as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u>
32	<u>Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.</u>
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema
101.CAL	XBRL Taxonomy Extension Calculation Linkbase
101.DEF	XBRL Taxonomy Extension Definition Linkbase
101.LAB	XBRL Taxonomy Extension Labels Linkbase
101.PRE	XBRL Taxonomy Extension Presentation Linkbase

---

\*Confidential treatment has been requested for certain portions of this exhibit. These portions have been omitted and filed separately with the SEC.



Table of Contents

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Date: November 7, 2018

Willis Lease Finance Corporation

By: /s/ Scott B. Flaherty  
Scott B. Flaherty  
Chief Financial Officer  
(Principal Accounting Officer)