

WILLIS LEASE FINANCE CORP

Form 10-Q

August 06, 2015

Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

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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 June 30, 2015

OR

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

Commission File Number: 001-15369

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WILLIS LEASE FINANCE CORPORATION

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(Exact name of registrant as specified in its charter)

Delaware  
(State or other jurisdiction of incorporation or organization)

68-0070656  
(IRS Employer Identification No.)

773 San Marin Drive, Suite 2215, Novato, CA  
(Address of principal executive offices)

94998  
(Zip Code)

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

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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 and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted 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 and post such files). Yes No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer  
(Do not check if a smaller reporting company)

Smaller reporting company

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

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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 July 31, 2015
Common Stock, \$0.01 par value per share	8,346,425

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Table of Contents

WILLIS LEASE FINANCE CORPORATION  
AND SUBSIDIARIES

INDEX

PART I. FINANCIAL INFORMATION

<u>Item 1.</u>	<u>Consolidated Financial Statements (Unaudited)</u>	3
	<u>Consolidated Balance Sheets as of June 30, 2015 and December 31, 2014</u>	3
	<u>Consolidated Statements of Income for the three and six months ended June 30, 2015 and 2014</u>	4
	<u>Consolidated Statements of Comprehensive Income for the three and six months ended June 30, 2015 and 2014</u>	5
	<u>Consolidated Statements of Shareholders' Equity for the six months ended June 30, 2015 and 2014</u>	6
	<u>Consolidated Statements of Cash Flows for the six months ended June 30, 2015 and 2014</u>	7
	<u>Notes to Unaudited Consolidated Financial Statements</u>	8
<u>Item 2.</u>	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	19
<u>Item 3.</u>	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	27
<u>Item 4.</u>	<u>Controls and Procedures</u>	27
<u>PART II. OTHER INFORMATION</u>		
<u>Item 2.</u>	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	28
<u>Item 5.</u>	<u>Other Information</u>	29
<u>Item 6.</u>	<u>Exhibits</u>	30

Table of Contents

## PART I — FINANCIAL INFORMATION

## Item 1. Consolidated Financial Statements (Unaudited)

WILLIS LEASE FINANCE CORPORATION  
AND SUBSIDIARIES

## Consolidated Balance Sheets

(In thousands, except share data, unaudited)

	June 30, 2015	December 31, 2014
<b>ASSETS</b>		
Cash and cash equivalents	\$ 16,172	\$ 13,493
Restricted cash	50,686	51,258
Equipment held for operating lease, less accumulated depreciation of \$294,842 and \$281,087 at June 30, 2015 and December 31, 2014, respectively	1,063,950	1,066,448
Equipment held for sale	29,352	18,114
Spare parts inventory	19,006	18,593
Operating lease related receivable, net of allowances of \$265 and \$215 at June 30, 2015 and December 31, 2014, respectively	13,692	8,912
Investments	42,789	41,590
Property, equipment & furnishings, less accumulated depreciation of \$10,150 and \$9,420 at June 30, 2015 and December 31, 2014, respectively	20,828	17,955
Intangible assets, net	1,048	1,164
Other assets	24,704	24,099
<b>Total assets</b>	<b>\$ 1,282,227</b>	<b>\$ 1,261,626</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>Liabilities:</b>		
Accounts payable and accrued expenses	\$ 19,730	\$ 21,614
Deferred income taxes	91,443	90,510
Notes payable	860,979	840,956
Maintenance reserves	67,770	66,474
Security deposits	19,359	20,869
Unearned lease revenue	5,018	4,342
<b>Total liabilities</b>	<b>1,064,299</b>	<b>1,044,765</b>

Shareholders' equity:

Common stock (\$0.01 par value, 20,000,000 shares authorized; 8,221,425 and 8,346,304 shares issued and outstanding at June 30, 2015 and December 31, 2014, respectively)	82	83
Paid-in capital in excess of par	41,338	42,076
Retained earnings	176,508	174,702
Total shareholders' equity	217,928	216,861
Total liabilities and shareholders' equity	\$ 1,282,227	\$ 1,261,626

See accompanying notes to the unaudited consolidated financial statements.

Table of Contents

## WILLIS LEASE FINANCE CORPORATION

## AND SUBSIDIARIES

## Consolidated Statements of Income

(In thousands, except per share data, unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2015	2014	2015	2014
<b>REVENUE</b>				
Lease rent revenue	\$ 25,813	\$ 24,801	\$ 50,910	\$ 51,701
Maintenance reserve revenue	10,477	14,560	24,625	28,590
Spare parts sales	2,866	1,643	5,017	2,061
Gain on sale of leased equipment	3,234	1,591	3,896	1,822
Other revenue	833	1,270	1,589	3,031
Total revenue	43,223	43,865	86,037	87,205
<b>EXPENSES</b>				
Depreciation and amortization expense	17,668	15,735	35,373	31,445
Cost of spare parts sales	2,200	1,614	3,680	1,954
Write-down of equipment	3,058	2,183	3,082	2,478
General and administrative	9,112	9,261	19,084	18,947
Technical expense	2,434	2,370	4,266	3,890
Net finance costs:				
Interest expense	9,860	9,396	19,427	18,755
Gain on debt extinguishment	—	—	(1,151)	—
Total net finance costs	9,860	9,396	18,276	18,755
Total expenses	44,332	40,559	83,761	77,469
Earnings (loss) from operations	(1,109)	3,306	2,276	9,736
Earnings from joint ventures	215	245	569	551
Income (loss) before income taxes	(894)	3,551	2,845	10,287
Income tax (expense) benefit	402	(1,337)	(1,039)	(3,742)
Net income (loss)	\$ (492)	\$ 2,214	\$ 1,806	\$ 6,545
Basic earnings (loss) per common share:	\$ (0.06)	\$ 0.28	\$ 0.23	\$ 0.82
Diluted earnings (loss) per common share:	\$ (0.06)	\$ 0.27	\$ 0.23	\$ 0.80
Average common shares outstanding	7,841	7,976	7,845	7,946

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Diluted average common shares outstanding	7,991	8,179	8,022	8,164
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See accompanying notes to the unaudited consolidated financial statements.

4

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Table of Contents

## WILLIS LEASE FINANCE CORPORATION

## AND SUBSIDIARIES

## Consolidated Statements of Comprehensive Income

(In thousands, unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2015	2014	2015	2014
Net income (loss)	\$ (492)	\$ 2,214	\$ 1,806	\$ 6,545
Other comprehensive loss:				
Derivative instruments				
Reclassification adjustment for gains included in net income	—	(124)	—	(249)
Net loss recognized in other comprehensive income	—	(124)	—	(249)
Tax benefit related to items of other comprehensive income	—	46	—	91
Other comprehensive loss	—	(78)	—	(158)
Total comprehensive income (loss)	\$ (492)	\$ 2,136	\$ 1,806	\$ 6,387

See accompanying notes to the unaudited consolidated financial statements.

Table of ContentsWILLIS LEASE FINANCE CORPORATION  
AND SUBSIDIARIES

## Consolidated Statements of Shareholders' Equity

Six Months Ended June 30, 2015 and 2014

(In thousands, unaudited)

	Issued and Outstanding Shares of Common Stock	Common Stock	Paid-in Capital in Excess of par	Accumulated Other Comprehensive Income	Retained Earnings	Total Shareholders' Equity
Balances at December 31, 2013	8,400	\$ 84	\$ 44,741	\$ 325	\$ 167,455	\$ 212,605
Net income	—	—	—	—	6,545	6,545
Unrealized loss from derivative instruments, net of tax benefit of \$91	—	—	—	(158)	—	(158)
Shares repurchased	(60)	—	(1,214)	—	—	(1,214)
Shares issued under stock compensation plans	83	1	330	—	—	331
Cancellation of restricted stock units in satisfaction of withholding tax	(49)	(1)	(933)	—	—	(934)
Stock-based compensation, net of forfeitures	—	—	1,642	—	—	1,642
Balances at June 30, 2014	8,374	\$ 84	\$ 44,566	\$ 167	\$ 174,000	\$ 218,817
Balances at December 31, 2014	8,346	\$ 83	\$ 42,076	\$ —	\$ 174,702	\$ 216,861
Net income	—	—	—	—	1,806	1,806
Shares repurchased	(108)	(1)	(2,038)	—	—	(2,039)

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Shares issued under stock compensation plans	26	1	84	—	—	85
Cancellation of restricted stock units in satisfaction of withholding tax	(43)	(1)	(861)	—	—	(862)
Stock-based compensation, net of forfeitures	—	—	1,947	—	—	1,947
Tax benefit on disqualified disposition of shares	—	—	130	—	—	130
Balances at June 30, 2015	8,221	\$ 82	\$ 41,338	\$ —	\$ 176,508	\$ 217,928

See accompanying notes to the unaudited consolidated financial statements.

Table of ContentsWILLIS LEASE FINANCE CORPORATION  
AND SUBSIDIARIES

## Consolidated Statements of Cash Flows

(In thousands, unaudited)

	Six Months Ended June 30,	
	2015	2014
Cash flows from operating activities:		
Net income	\$ 1,806	\$ 6,545
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization expense	35,373	31,445
Write-down of equipment	3,082	2,478
Stock-based compensation expenses	1,947	1,642
Amortization of deferred costs	2,127	2,042
Amortization of interest rate derivative cost	—	(249)
Allowances and provisions	50	9
Gain on sale of leased equipment	(3,896)	(1,822)
Gain on debt extinguishment	(1,151)	—
Income from joint ventures	(569)	(551)
Deferred income taxes	933	3,252
Changes in assets and liabilities:		
Receivables	(4,830)	3,440
Spare parts inventory	(413)	(10,734)
Other assets	(2,722)	2,942
Accounts payable and accrued expenses	(3,473)	2,590
Restricted cash	2,341	(6,056)
Maintenance reserves	1,296	(2,232)
Security deposits	(464)	4
Unearned lease revenue	676	275
Net cash provided by operating activities	32,113	35,020
Cash flows from investing activities:		
Proceeds from sale of equipment (net of selling expenses)	33,912	11,587
Restricted cash for investing activities	(15,906)	12,303
Capital contribution to joint ventures	(630)	—
Purchase of equipment held for operating lease and for sale	(74,764)	(21,724)
Purchase of property, equipment and furnishings	(3,617)	(201)
Net cash provided by (used in) investing activities	(61,005)	1,965
Cash flows from financing activities:		
Proceeds from issuance of notes payable	118,700	10,000

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Debt issuance cost	(13)	(4,837)
Interest bearing security deposits	(1,046)	3,035
Proceeds from shares issued under stock compensation plans	85	331
Cancellation of restricted stock units in satisfaction of withholding tax	(862)	(934)
Excess tax benefit from stock-based compensation	130	—
Repurchase of common stock	(2,039)	(1,214)
Principal payments on notes payable	(97,521)	(43,795)
Decrease in restricted cash	14,137	—
Net cash provided by (used in) financing activities	31,571	(37,414)
Increase (decrease) in cash and cash equivalents	2,679	(429)
Cash and cash equivalents at beginning of period	13,493	12,801
Cash and cash equivalents at end of period	\$ 16,172	\$ 12,372
Supplemental disclosures of cash flow information:		
Net cash paid for:		
Interest	\$ 17,675	\$ 16,995
Income Taxes	\$ 79	\$ 119

Supplemental disclosures of non-cash investing activities:

During the six months ended June 30, 2015 and 2014, a liability of \$822 and \$802, respectively, was incurred but not paid in connection with our purchase of aircraft and engines.

During the six months ended June 30, 2015 and 2014, engines and equipment totaling \$15,377 and \$1,684, respectively, were transferred from Held for Operating Lease to Held for Sale but not sold.

See accompanying notes to the unaudited consolidated financial statements.

Table of Contents

Notes to Unaudited Consolidated Financial Statements

1. Summary of Significant Accounting Policies

(a) Basis of Presentation: Our unaudited consolidated financial statements include the accounts of Willis Lease Finance Corporation and its subsidiaries (“we” or the “Company”) and have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission for reporting on Form 10-Q. Pursuant to such rules and regulations, certain information and note disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted. The accompanying unaudited interim consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto, together with Management’s Discussion and Analysis of Financial Condition and Results of Operations, contained in our Annual Report on Form 10-K for the fiscal year ended December 31, 2014.

In the opinion of management, the accompanying unaudited consolidated financial statements contain all adjustments (consisting of only normal and recurring adjustments) necessary to present fairly our financial position as of June 30, 2015 and December 31, 2014, and the results of our operations for the three and six months ended June 30, 2015 and 2014, and our cash flows for the six months ended June 30, 2015 and 2014. The results of operations and cash flows for the period ended June 30, 2015 are not necessarily indicative of the results of operations or cash flows which may be reported for the remainder of 2015.

(b) Correction of Immaterial Errors – Consolidated Statements of Income:

During the second quarter of 2015, we identified errors in the Unaudited Consolidated Statements of Income for the three and six month periods ended June 30, 2014, and the Unaudited Consolidated Cash Flow Statement for the six month period ended June 30, 2014 related to the recorded amounts of Spare Parts Sales, Cost of Spare Parts Sales and Gain on Sale of Equipment. During these periods, we inappropriately recorded spare parts on a net basis and the gross margin was recorded to Gain on Sale of Equipment. We also recorded purchases and sales of spare parts in investing cash flows instead of operating cash flows. There was no impact to net income for any period presented.

The associated reclassification entries within the Statements of Incomes were to increase Spare Parts Sales by \$1.6 million and \$2.1 million for the three and six month periods ended June 30, 2014, increase Cost of Spare Parts Sales by \$1.6 million and \$2.0 million, and decrease Gain on Sale of Leased Equipment by \$29,000 and \$0.1 million for the three and six month periods ended June 30, 2014. The impact to the cash flow statement was to understate cash flows provided by operations by \$0.6 million and overstate cash flows provided by investing activities for the six month

period ended June 30, 2014.

Management evaluated the materiality of the errors described above from a qualitative and quantitative perspective in accordance with the requirements of the Securities and Exchange Commission (SEC) Staff Accounting Bulletin No. 99, Materiality (SAB 99). Based on such evaluation, we have concluded that these corrections would not be material to any individual prior period nor did they have an effect on financial results.

(c) Fair Value Measurements:

Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. Valuation techniques used to measure fair value must maximize the use of observable inputs and minimize the use of unobservable inputs, to the extent possible. We use a fair

Table of Contents

value hierarchy based on three levels of inputs, of which the first two are considered observable and the last unobservable, to measure fair value which are the following:

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.

#### Assets Measured and Recorded at Fair Value on a Nonrecurring Basis

We determine 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 value.

The following table shows by level, within the fair value hierarchy, the Company's assets measured at fair value on a nonrecurring basis as of June 30, 2015 and 2014, and the gains (losses) recorded during the six months ended June 30, 2015 and 2014 on those assets:

	Assets at Fair Value								Total Losses	
	June 30, 2015				June 30, 2014				Six Months Ended	
	Total (in thousands)	Level 1	Level 2	Level 3	Total	Level 1	Level 2	Level 3	2015	2014
Equipment held for sale	\$ 15,757	\$ —	\$ 6,211	\$ 9,546	\$ 3,586	\$ —	\$ —	\$ 3,586	\$ (3,082)	\$ (2,478)
Total	\$ 15,757	\$ —	\$ 6,211	\$ 9,546	\$ 3,586	\$ —	\$ —	\$ 3,586	\$ (3,082)	\$ (2,478)



At June 30, 2015, the Company used Level 2 inputs to measure the fair value of certain engines and equipment held for sale. Due to the absence of quoted market prices of certain engines that were held for sale and not consigned to third parties, management used Level 3 inputs to measure fair value. The fair value of the assets held for sale categorized as Level 3 were based on management's estimate considering projected future sales proceeds at June 30, 2015 and June 30, 2014.

An impairment charge is recorded when the carrying value of the asset held for sale exceeds its fair value. Write-downs of equipment totaling \$3.1 million were recorded in the three and six months ended June 30, 2015 due to a management decision to consign two engines for part-out and sale, in which the assets' net book value exceeded the estimated proceeds from part-out. Write-downs of equipment totaling \$2.2 million and \$2.5 million were recorded in the three and six months ended June 30, 2014, respectively, due to a management decision to consign five engines for part-out and sale, in which the assets' net book value exceeded the estimated proceeds from part-out.

(d) Recent Accounting Pronouncements:

In July 2015, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU"), Simplifying the Measurement of Inventory, which simplifies the measurement of inventory by requiring certain inventory to be measured at the lower of cost or net realizable value. The amendments in this ASU are effective for fiscal years beginning after December 15, 2016 and for interim periods therein. We are evaluating the impact that this new guidance will have on our consolidated financial position.

Table of Contents

In April 2015, the FASB issued ASU, Simplifying the Presentation of Debt Issuance Costs, which will more closely align the presentation of debt issuance costs under U.S. GAAP with the presentation under comparable IFRS standards by requiring that debt issuance costs be presented on the balance sheet as a direct deduction from the carrying amount of the related debt liability, similar to the presentation of debt discounts or premiums. This accounting guidance is effective for us beginning in the first quarter of 2016. The unamortized debt issuance cost balances were \$13.8 million and \$15.5 million as of June 30, 2015 and December 31, 2014, respectively, and would reduce our Notes Payable balances accordingly on our Consolidated Balance Sheet for those periods under this ASU.

In May 2014, the FASB issued an ASU, Revenue from Contracts with Customers, which supersedes previous revenue recognition guidance. The new standard requires that a company recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration the company expects to receive in exchange for those goods or services. Companies will need to use more judgment and estimates than under the guidance currently in effect, including estimating the amount of variable revenue to recognize over each identified performance obligation. Additional disclosures will be required to help users of financial statements understand the nature, amount and timing of revenue and cash flows arising from contracts. In July 2015, the FASB deferred the effective date for annual reporting periods beginning after December 15, 2017 (including interim reporting periods within those periods). Early adoption is permitted to the original effective date of December 15, 2016 (including interim reporting periods within those periods). The amendments may be applied retrospectively to each prior period presented or retrospectively with the cumulative effect recognized as of the date of initial application. The Company is currently evaluating the impact of adopting this new guidance on the consolidated financial statements.

## 2. Management Estimates

These financial statements have been prepared on the accrual basis of accounting in accordance with accounting principles generally accepted in the United States.

The preparation of consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an ongoing basis, we evaluate our estimates, including those related to residual values, estimated asset lives, impairments and bad debts. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

Management believes that the accounting policies on revenue recognition, maintenance reserves and expenditures, useful life of equipment, asset residual values, asset impairment and allowance for doubtful accounts are critical to the results of operations.

If the useful lives or residual values are lower than those estimated by us, upon sale of the asset a loss may be realized. Significant management judgment is required in the forecasting of future operating results, which are used in the preparation of projected undiscounted cash-flows and should different conditions prevail, material impairment write-downs may occur.

Table of Contents

## 3. Investments

On May 25, 2011, we entered into an agreement with Mitsui & Co., Ltd. to participate in a joint venture formed as a Dublin-based Irish limited company — Willis Mitsui & Company Engine Support Limited (“WMES”) for the purpose of acquiring and leasing jet engines. Each partner holds a fifty percent interest in the joint venture. The initial capital contribution by the Company for its investment in WMES was \$8.0 million. The Company provided the initial lease portfolio by transferring 7 engines to the joint venture in June 2011. In addition, the Company made \$20.4 million capital contributions to WMES from 2011 through 2014 for the purchase of 21 engines from third parties, increasing the number of engines in the lease portfolio to 28. The Company made \$0.6 million of capital contributions to WMES and recorded \$0.6 million as a result of the Company’s share of WMES reported earnings during the six months ended June 30, 2015. The \$29.0 million of capital contributions has been partially offset by \$3.6 million, resulting in a net investment of \$25.4 million, which has been reduced by \$0.8 million in distributions and increased further to \$28.0 million as of June 30, 2015 as a result of the Company’s share of WMES reported earnings to date. The \$3.6 million reduction in investment represents 50% of the \$7.2 million gain related to the sale by the Company of the 7 engines to WMES.

On June 3, 2014 we entered into an agreement with China Aviation Supplies Import & Export Corporation Limited (“CASC”) to participate in a joint venture named CASC Willis Engine Lease Company Limited (“CASC Willis”), a new joint venture based in Shanghai, China. Each partner holds a fifty percent interest in the joint venture. In October 2014, each partner made a \$15.0 million initial capital contribution representing the up-front funding for the new joint venture. The new company will acquire and lease jet engines to Chinese airlines and will concentrate on meeting the fast growing demand for leased commercial aircraft engines and aviation assets in the People’s Republic of China. The investment has been reduced to \$14.8 million as of June 30, 2015 as a result of the Company’s share of CASC Willis reported losses to date.

Six Months Ended June 30, 2015	CASC		Total
	WMES	Willis	
	(in thousands)		
Investment in joint ventures as of December 31, 2014	\$ 26,672	\$ 14,918	\$ 41,590
Capital contribution	630	—	630
Earnings (loss) from joint venture	644	(75)	569
Investment in joint ventures as of June 30, 2015	\$ 27,946	\$ 14,843	\$ 42,789

#### 4. Long Term Debt

At June 30, 2015, notes payable consists of loans totaling \$861.0 million, payable over periods of approximately 2.2 to 9.1 years with interest rates varying between approximately 2.4% and 5.5%.

At June 30, 2015, we had a revolving credit facility to finance the acquisition of aircraft engines for lease as well as for general working capital purposes, with the amounts drawn under the facility not to exceed that which is allowed under the borrowing base as defined by the credit agreement. On June 4, 2014, we entered into a Second Amended and Restated Credit Agreement which increased this revolving credit facility to \$700.0 million from \$450.0 million and extended the maturity date by five years to June 2019. Debt issuance costs totaling \$4.9 million were incurred related to the new facility. As of June 30, 2015 and December 31, 2014, \$205.0 million and \$270.0 million were available under this facility, respectively. On a quarterly basis, the interest rate is adjusted based on the Company's leverage ratio, as calculated under the terms of the revolving credit facility. Based on the Company's leverage ratio of 4.14 at March 31, 2015, the interest rate on this facility is one-month LIBOR plus 2.75% as of June 30, 2015. Under the revolving credit facility, all subsidiaries except WEST II and WOLF jointly and severally guarantee payment and performance of the terms of the loan agreement. The guarantee would be triggered by a default under the agreement.

Table of Contents

On September 17, 2012, we closed an asset-backed securitization (“ABS”) through a newly-created, bankruptcy-remote, Delaware statutory trust, Willis Engine Securitization Trust II, or “WEST II”, of which the Company is the sole beneficiary. WEST II issued and sold \$390 million aggregate principal amount of Class 2012-A Term Notes (the “Notes”) and received \$384.9 million in net proceeds. We used these funds, net of transaction expenses and swap termination costs, in combination with our revolving credit facility to pay off the prior WEST notes totaling \$435.9 million. At closing, 22 engines were pledged as collateral from WEST to the Company’s revolving credit facility, which provided the remaining funds to pay off the WEST notes.

The assets and liabilities of WEST II are included on the Company’s balance sheet. The current portfolio of 65 commercial jet aircraft engines and leases thereof secures the obligations of WEST II under the ABS. The Notes have no fixed amortization and are payable solely from revenue received by WEST II from the engines and the engine leases, after payment of certain expenses of WEST II. The Notes bear interest at a fixed rate of 5.50% per annum. The Notes may be accelerated upon the occurrence of certain events, including the failure to pay interest for five business days after the due date thereof. The Notes are expected to be paid 10 years from the issuance date by September 17, 2022. The legal final maturity of the Notes is September 15, 2037.

In connection with the transactions described above, effective September 17, 2012, the Company entered into a Servicing Agreement and Administrative Agency Agreement with WEST II to provide certain engine, lease management and reporting functions for WEST II in return for fees based on a percentage of collected lease revenues and asset sales. Because WEST II is consolidated for financial statement reporting purposes, all fees eliminate upon consolidation.

At June 30, 2015 and December 31, 2014, \$327.8 million and \$351.9 million of WEST II term notes were outstanding, respectively. The assets of WEST II are not available to satisfy our obligations or any of our affiliates other than the obligations specific to WEST II. WEST II is consolidated for financial statement presentation purposes. WEST II’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 II’s maintenance of adequate reserves and capital. Under WEST II, 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 maintenance reserve payments and all lease security deposits are accumulated in restricted accounts and are available to fund future maintenance events and to secure lease payments, respectively. Cash from maintenance reserve payments are held in the restricted cash account equal to the maintenance obligations projected for the subsequent six months, and are subject to a minimum balance of \$9.0 million.

On March 25, 2015, we paid off the \$23.1 million balance of the two term notes associated with the WOLF assets at a 5% discount. This transaction resulted in the recording of a \$1.2 million gain on debt extinguishment which has been included in our statement of operations for the six months ended June 30, 2015.

On July 16, 2014, we closed on a loan for a ten year term totaling \$13.4 million. During the second quarter of 2015, we closed on two additional loans totaling \$4.7 million, repayable over the same ten year term. The interest is payable at fixed rates ranging from 2.60% to 2.97% for the initial five years of the loan term and principal and interest is paid monthly. The loans provided 100% of the funding for the purchase of a corporate aircraft and subsequent modifications and upgrades. The balance outstanding on these loans is \$17.0 million and \$12.9 million as of June 30, 2015 and December 31, 2014, respectively.

On January 10, 2014, we extended the term of an existing loan that was scheduled to mature on January 11, 2014. The loan has a term of 4 years with a maturity date of January 11, 2018. Interest is payable at one-month LIBOR plus 2.25% and principal and interest is paid quarterly. The loan is secured by three engines. The balance outstanding on this loan is \$13.8 million and \$14.5 million as of June 30, 2015 and December 31, 2014, respectively.

On September 28, 2012, we closed on a loan for a five year term totaling \$8.7 million. Interest is payable at a fixed rate of 5.50% and principal and interest is paid quarterly. The loan is secured by one engine. The funds were

Table of Contents

used to purchase the engine secured under the loan. The balance outstanding on this loan is \$7.4 million and \$7.7 million as of June 30, 2015 and December 31, 2014, respectively.

One-month LIBOR was 0.19% and 0.17% at June 30, 2015 and December 31, 2014, respectively.

The following is a summary of the aggregate maturities of notes payable at June 30, 2015:

Year	(in thousands)
2015	\$ 11,679
2016	24,383
2017	31,548
2018	34,626
2019	519,788
Thereafter	238,955
	\$ 860,979

5. Derivative Instruments

We have periodically held interest rate derivative instruments to mitigate exposure to changes in interest rates, in particular one-month LIBOR, with \$508.8 million and \$468.5 million of our borrowings at June 30, 2015 and December 31, 2014, respectively, at variable rates. As a matter of policy, we do not use derivatives for speculative purposes. We currently have no interest rate swap agreements in place. During 2013 we were a party to one interest rate swap agreement with a notional outstanding amount of \$100.0 million with a fixed rate of 2.10%. The swap agreement expired in November 2013. The remaining effective portion of these hedges at the swap expiration date was amortized into earnings over the term of the underlying borrowings. We recorded a \$0.1 million and \$0.2 million benefit to net finance costs during the three and six month periods ended June 30, 2014, respectively.



The Company estimates the fair value of derivative instruments using a discounted cash flow technique and uses creditworthiness inputs that can be corroborated by observable market data evaluating the Company's and counterparties' 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. We apply hedge accounting and account for the change in fair value of our cash flow hedges through other comprehensive income for all derivative instruments.

#### Earnings Effects of Derivative Instruments on the Consolidated Statements of Income

The following table provides information about the income effects of our cash flow hedging relationships for the three and six month periods ended June 30, 2015 and 2014:

Derivatives in Cash Flow Hedging Relationships	Location of Gain Recognized on Derivatives in the Statements of Income	Amount of Gain Recognized on Derivatives in the Statements of Income			
		Three Months Ended June 30,		Six Months Ended June 30,	
		2015	2014	2015	2014
		(in thousands)			
Interest rate contracts	Interest expense	\$ —	\$ (124)	\$ —	\$ (249)
Total		\$ —	\$ (124)	\$ —	\$ (249)

Our derivatives are 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.

Table of Contents

## Effect of Derivative Instruments on Cash Flow Hedging

The following tables provide additional information about the financial statement effects related to our cash flow hedges for the three and six month periods ended June 30, 2015 and 2014:

Location of Gain Reclassified from Accumulated OCI into Income (Effective Portion)	Amount of Gain Reclassified from Accumulated OCI into Income (Effective Portion)			
	Three Months Ended June 30, 2015		Six Months Ended June 30, 2014	
	(in thousands)		(in thousands)	
Interest expense	\$ —	\$ 124	\$ —	\$ 249
Total	\$ —	\$ 124	\$ —	\$ 249

We hold interest rate derivative instruments from time to time to mitigate exposure to changes in interest rates, in particular one-month LIBOR, with \$508.8 million of our borrowings at June 30, 2014 at variable rates. The last of our interest rate derivatives terminated on November 25, 2013, at which time the liabilities under derivative instruments decreased to nil.

The change in fair value on a derivative instrument designated as a cash flow hedge is reported as a component of accumulated 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.

As of June 30, 2014, we had \$0.2 million in accumulated other comprehensive income related to a previously held derivative instrument designated as a cash flow hedge. This amount was reclassified into interest expense through December 2014, the remaining term of the associated debt. For the quarters ended June 30, 2015 and June 30, 2014, interest expense was reduced by zero and \$0.1 million respectively, as a result of this reclassification out of accumulated other comprehensive income.

## Counterparty Credit Risk

The Company evaluates the creditworthiness of the counterparties under its hedging agreements. The swap counterparty for the interest rate swap in place during the first eleven months of 2013 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 had not required the counterparty to provide collateral or other security to the Company.

## 6. Stock-Based Compensation Plans

Our 2007 Stock Incentive Plan (the 2007 Plan) was adopted on May 24, 2007. Under this 2007 Plan, a total of 2,000,000 shares are authorized for stock based compensation available in the form of either restricted stock or stock options. On May 28, 2015, the Company's shareholders authorized an increase in the number of shares of Common Stock available for grant by 800,000 shares bringing the total to 2,800,000 shares authorized. 2,138,712 shares of restricted stock were granted under the 2007 Stock Incentive Plan by June 30, 2015. Of this amount, 135,368 shares of restricted stock were withheld or forfeited and returned to the pool of shares which could be granted under the 2007 Stock Incentive Plan resulting in a net number of 796,656 shares which were available as of June 30, 2015 for future issuance under the 2007 Incentive Plan. The fair value of the restricted stock awards

Table of Contents

equaled the stock price at the date of grants. The following table summarizes restricted stock activity during the year ended December 31, 2014 and the six months ended June 30, 2015.

	Shares
Restricted stock at December 31, 2013	515,130
Granted in 2014 (vesting over 3 years)	174,500
Granted in 2014 (vesting over 4 years)	13,000
Granted in 2014 (vesting on first anniversary from date of issuance)	50,208
Cancelled in 2014	(5,750)
Vested in 2014	(221,732)
Restricted stock at December 31, 2014	525,356
Granted in 2015 (vesting over 1 year)	16,440
Granted in 2015 (vesting over 4 years)	5,000
Vested in 2015	(142,481)
Restricted stock at June 30, 2015	404,315

All cancelled shares have reverted to the share reserve and are available for issuance at a later date, in accordance with the 2007 Plan.

Our accounting policy is to recognize the associated expense of such awards on a straight-line basis over the vesting period. At June 30, 2015, the stock compensation expense related to the restricted stock awards that will be recognized over the average remaining vesting period of 1.7 years totals \$4.6 million. At June 30, 2015, the intrinsic value of unvested restricted stock awards is \$7.4 million. The 2007 Plan terminates on May 24, 2017.

In the six months ended June 30, 2015, no options under the 1996 Stock Options/Stock Issuance Plan (the 1996 Plan) were exercised. As of June 30, 2015, there are 49,000 stock options remaining under the 1996 Plan which have an intrinsic value of \$0.5 million.

## 7. Income Taxes

Income tax expense (benefit) for the three and six months ended June 30, 2015 was (\$0.4 million) and \$1.0 million respectively. Income tax expense for the three and six months ended June 30, 2014 was \$1.3 million and \$3.7 million respectively. The effective tax rate for the three and six months ended June 30, 2015 was 45.0% and 36.5%, respectively. The effective tax rate for the three and six months ended June 30, 2014 was 37.7% and 36.4%, respectively.

The Company records tax expense or benefit for unusual or infrequent items discretely in the period in which they occur. Our 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.

#### 8. Fair Value of Financial Instruments

The carrying amount reported in the consolidated balance sheets for cash and cash equivalents, restricted cash, operating lease related receivable and accounts payable approximates fair value because of the immediate or short-term maturity of these financial instruments.

The carrying amount of the Company's outstanding balance on its Notes Payable as of June 30, 2015 and December 31, 2014 was estimated to have a fair value of approximately \$871.7 million and \$847.0 million, respectively, based on the fair value of estimated future payments calculated using the prevailing interest rates at each year end.

Table of Contents

9. Operating Segments

The Company operates in two business 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 (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 and leasing of engines destined for disassembly and sale of parts.

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

Table of Contents

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

For the three months ended June 30, 2015	Leasing and		Eliminations (1)	Total
	Related Operations	Spare Parts Sales		
Revenue:				
Lease rent revenue	\$ 25,813	\$ —	\$ —	\$ 25,813
Maintenance reserve revenue	10,477	—	—	10,477
Spare parts sales	—	2,866	—	2,866
Gain on sale of leased equipment	3,234	—	—	3,234
Other revenue	813	100	(80)	833
Total revenue	40,337			