

WILLIS LEASE FINANCE CORP

Form 10-Q/A

August 03, 2005

## **SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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## FORM 10-Q/A

Amendment No. 1

(Mark One)

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

For the Quarterly Period Ended March 31, 2005

OR

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

Commission File Number: 0-28774

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## WILLIS LEASE FINANCE CORPORATION

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of incorporation or  
organization)

**68-0070656**

(IRS Employer Identification No.)

**2320 Marinship Way, Suite 300 Sausalito, CA**

(Address of principal executive offices)

**94965**

(Zip Code)

Registrant's telephone number, including area code **(415) 275-5100**

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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

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Indicate by check mark whether the registrant is an accelerated filer (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:

| <b>Title of Each Class</b>     | <b>Outstanding at May 10, 2005</b> |
|--------------------------------|------------------------------------|
| Common Stock, \$0.00 Par Value | 9,043,923                          |

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**EXPLANATORY NOTE**

Willis Lease Finance Corporation (the "Company") is filing this Amendment No. 1 to its Form 10-Q for the quarter ended March 31, 2005 (the "2005 First Quarter 10-Q"), which was originally filed on May 16, 2005, to address comments from the staff (the "Staff") of the Securities and Exchange Commission (the "SEC") in connection with the Staff's normal periodic review of the Company's filings. As a result of the review, the Company is restating its consolidated balance sheets for the period ended March 31, 2005 and December 31, 2004 and its consolidated statements of cash flows for the three months ended March 31, 2005 and 2004 and the related disclosures, to separately classify certain cash that is restricted in connection with the Company's borrowings. The restricted cash was previously disclosed in narrative form and included within the description for cash and cash equivalents. The consolidated statements of cash flows for the three months ended March 31, 2005 and 2004 have been restated to reflect the impact of this change. Please refer to Note 2 to the accompanying consolidated financial statements for additional information. This Amendment No. 1 does not result in a change in the Company's previously reported revenues, net income, earnings per share, total assets, total liabilities or total shareholders' equity as shown in all previous filings.

Also as a result of the Staff's review, disclosure was expanded in several areas of the 2005 First Quarter Form 10-Q. For the convenience of the reader, this Form 10-Q/A sets forth the complete text of the originally filed 2005 First Quarter 10-Q rather than just the amended portions thereof.

This Form 10-Q/A should be read in conjunction with the Company's Form 10-K/A for the year ended December 31, 2004 which is also filing today. The following items have been amended as a result of the restatements and reclassifications described above:

Part I Item 1 Financial Information

Part I Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations

Part I Item 4 Controls and Procedures

Part II Item 6 Exhibits

Part II Item 6 Exhibits

Exhibit 31.1 Certification Chief Executive Officer

Exhibit 31.1 Certification Chief Executive Officer

Exhibit 31.2 Certification Chief Financial Officer

Exhibit 32 Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

**WILLIS LEASE FINANCE CORPORATION  
AND SUBSIDIARIES**

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## WILLIS LEASE FINANCE CORPORATION

## AND SUBSIDIARIES

## Consolidated Balance Sheets

(In thousands, except share data, unaudited)

|   | March 31,<br>2005<br>(As restated) | December 31,<br>2004<br>(As restated) |
|---|------------------------------------|---------------------------------------|
| <b>ASSETS</b>   |                                    |                                       |
| Cash and cash equivalents   | \$ 2,756                           | \$ 5,540                              |
| Restricted cash   | 38,849                             | 46,324                                |
| Equipment held for operating lease, less accumulated depreciation of \$88,733 and \$83,881 at March 31, 2005 and December 31, 2004, respectively                            | 509,799                            | 511,443                               |
| Operating lease related receivable, net of allowances of \$415 and \$400 at March 31, 2005 and December 31, 2004, respectively  | 1,697                              | 1,630                                 |
| Notes receivable  | 4,717                              | 436                                   |
| Investments   | 1,480                              | 1,480                                 |
| Assets under derivative instruments   | 2,769                              | 1,398                                 |
| Property, equipment & furnishings, less accumulated depreciation of \$1,329 and \$1,259 at March 31, 2005 and December 31, 2004, respectively                               | 7,936                              | 7,537                                 |
| Other assets  | 8,960                              | 9,670                                 |
| <b>Total assets</b>   | <b>\$ 578,963</b>                  | <b>\$ 585,458</b>                     |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>  |                                    |                                       |
| <b>Liabilities:</b>   |                                    |                                       |
| Accounts payable and accrued expenses   | \$ 5,516                           | \$ 7,280                              |
| Deferred income taxes   | 28,293                             | 27,530                                |
| Notes payable   | 361,722                            | 369,840                               |
| Maintenance reserves  | 57,835                             | 56,871                                |
| Security deposits   | 2,154                              | 2,088                                 |
| Unearned lease revenue  | 5,257                              | 5,381                                 |
| <b>Total liabilities</b>  | <b>460,777</b>                     | <b>468,990</b>                        |
| <b>Shareholders' equity:</b>  |                                    |                                       |
| Preferred stock (\$0.01 par value, 5,000,000 shares authorized; none outstanding)   |                                    |                                       |
| Common stock, (\$0.01 par value, 20,000,000 shares authorized; 9,026,698 and 8,998,365 shares issued and outstanding at March 31, 2005 and December 31, 2004, respectively) | 90                                 | 90                                    |
| Paid-in capital in excess of par  | 62,787                             | 62,631                                |
| Accumulated other comprehensive income/(loss), net of tax expense of \$897 and \$355 at March 31, 2005 and December 31, 2004, respectively                                  | 1,962                              | 966                                   |
| Retained earnings   | 53,347                             | 52,781                                |
| <b>Total shareholders' equity</b>   | <b>118,186</b>                     | <b>116,468</b>                        |
| <b>Total liabilities and shareholders' equity</b>   | <b>\$ 578,963</b>                  | <b>\$ 585,458</b>                     |

See accompanying notes to the unaudited consolidated financial statements

## WILLIS LEASE FINANCE CORPORATION

## AND SUBSIDIARIES

## Consolidated Statements of Income

(In thousands, except share data, unaudited)

|   | Three Months Ended<br>March 31, |           |
|---|---------------------------------|-----------|
|   | 2005                            | 2004      |
| <b>REVENUE</b>                            |                                 |           |
| Lease revenue                             | \$ 15,035                       | \$ 14,764 |
| Gain on sale of leased equipment          | 732                             | 148       |
| Other income                              | 101                             | 174       |
| Total revenue                             | 15,868                          | 15,086    |
| <b>EXPENSES</b>                           |                                 |           |
| Depreciation expense                      | 6,040                           | 5,722     |
| Net finance costs                         |                                 |           |
| Interest expense                          | 5,603                           | 4,363     |
| Interest income                           | (208)                           | (58)      |
| General and administrative                | 3,647                           | 3,691     |
| Total expenses                            | 15,082                          | 13,718    |
| Income before income taxes                | 786                             | 1,368     |
| Income tax expense                        | (220)                           | (399)     |
| Net income                                | \$ 566                          | \$ 969    |
| Basic earnings per common share:          | \$ 0.06                         | \$ 0.11   |
| Diluted earnings per common share:        | \$ 0.06                         | \$ 0.11   |
| Average common shares outstanding         | 9,006                           | 8,856     |
| Diluted average common shares outstanding | 9,401                           | 9,161     |

See accompanying notes to the unaudited consolidated financial statements



## WILLIS LEASE FINANCE CORPORATION

## AND SUBSIDIARIES

## Consolidated Statements of Shareholders Equity and Comprehensive Income

Three Months Ended March 31, 2005 and 2004

(In thousands, unaudited)

|  | Issued and<br>Outstanding<br>Shares of<br>Common<br>Stock | Common<br>Stock | Paid-in<br>Capital in<br>Excess of<br>par | Accumulated<br>Other<br>Comprehensive<br>Income/(Loss)<br>(net) | Retained<br>Earnings | Total<br>Shareholders<br>Equity |
|--|---|-----------------|---|---|----------------------|---------------------------------|
| Balances at December 31, 2003                                    | 8,847   | \$ 88           | \$ 61,710                                 | \$ (660)  | \$ 48,924            | \$ 110,062                      |
| Net Income   |   |                 |   |   | 969                  | 969                             |
| Other comprehensive income                                       |   |                 |   |   |                      |                                 |
| Net loss on cashflow hedging<br>instruments, net of tax of \$192 |   |                 |   | (467)   |                      | (467)                           |
| Total comprehensive income                                       |   |                 |   |   |                      | 502                             |
| Shares issued under stock<br>compensation plans                  | 40  | 1               | 205                                       |   |                      | 206                             |
| Balances at March 31, 2004                                       | 8,887   | \$ 89           | \$ 61,915                                 | \$ (1,127)  | \$ 49,893            | \$ 110,770                      |
| Balances at December 31, 2004                                    | 8,998   | \$ 90           | \$ 62,631                                 | \$ 966  | \$ 52,781            | \$ 116,468                      |
| Net Income   |   |                 |   |   | 566                  | 566                             |
| Other comprehensive income                                       |   |                 |   |   |                      |                                 |
| Net gain on cashflow hedging<br>instruments, net of tax of \$542 |   |                 |   | 996   |                      | 996                             |
| Total comprehensive income                                       |   |                 |   |   |                      | 1,562                           |
| Shares issued under stock<br>compensation plans                  | 29  |                 | 156                                       |   |                      | 156                             |
| Balances at March 31, 2005                                       | 9,027   | \$ 90           | \$ 62,787                                 | \$ 1,962  | \$ 53,347            | \$ 118,186                      |

See accompanying notes to the unaudited consolidated financial statements

## WILLIS LEASE FINANCE CORPORATION

## AND SUBSIDIARIES

## Consolidated Statements of Cash Flows

(In thousands, unaudited)

|  | Three Months ended March 31, |               |
|--|------------------------------|---------------|
|  | 2005                         | 2004          |
|  | (As restated)                | (As restated) |
| <b>Cash flows from operating activities:</b>                                       |                              |               |
| Net income   | \$ 566                       | \$ 969        |
| Adjustments to reconcile net income to net cash provided by operating activities:  |                              |               |
| Depreciation expense   | 6,040                        | 5,722         |
| Amortization   | 1,454                        | 1,212         |
| Amortization of loan discount  |                              | 130           |
| Allowances and provisions  | 15                           | 25            |
| Gain on sale of leased equipment   | (732)                        | (148)         |
| Changes in assets and liabilities:   |                              |               |
| Receivables  | (82)                         | (2,079)       |
| Other assets   | (530)                        | 431           |
| Accounts payable and accrued expenses  | (1,764)                      | 2,605         |
| Deferred income taxes  | 220                          | 396           |
| Restricted cash  | 7,475                        | 175           |
| Maintenance reserves   | 4,169                        | 357           |
| Security deposits  | 66                           | (93)          |
| Unearned lease revenue   | (124)                        | (1,184)       |
| Net cash provided by operating activities  | 16,773                       | 8,518         |
| <b>Cash flows from investing activities:</b>                                       |                              |               |
| Proceeds from sale of equipment held for operating lease (net of selling expenses) | 1,529                        | 386           |
| Proceeds from principal payment of notes receivable                                | 69                           |               |
| Purchase of equipment held for operating lease                                     | (12,692)                     | (3,466)       |
| Purchase of property, equipment and furnishings                                    | (469)                        | (70)          |
| Net principal payments received on direct finance lease                            |                              | 298           |
| Net cash (used in)/provided by investing activities                                | (11,563)                     | (2,852)       |
| <b>Cash flows from financing activities:</b>                                       |                              |               |
| Proceeds from issuance of notes payable  | 16,916                       | 5,000         |
| Proceeds from issuance of common stock   | 124                          | 206           |
| Principal payments on notes payable  | (25,034)                     | (16,823)      |
| Net cash (used in)/provided by financing activities                                | (7,994)                      | (11,617)      |
| Decrease in cash and cash equivalents  | (2,784)                      | (5,951)       |
| Cash and cash equivalents at beginning of period                                   | 5,540                        | 9,202         |
| Cash and cash equivalents at end of period   | \$ 2,756                     | \$ 3,251      |
| Supplemental disclosures of cash flow information:                                 |                              |               |
| Net cash paid for:   |                              |               |
| Interest   | \$ 4,867                     | \$ 3,936      |
| Income Taxes   | \$ 18                        | \$ 24         |

## Supplemental disclosure of non-cash investing activities:

In March 2005, a note receivable of \$4,350 was received in connection with the Company's sale of an engine.

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During the three months ended March 31, 2005, \$3,205 of maintenance reserves were included in the gain on the sale of leased equipment.

See accompanying notes to the unaudited consolidated financial statements.

**Notes to Consolidated Financial Statements**

1. **Basis of PRESENTATION**

**Consolidated Financial Statements**

The accompanying unaudited consolidated financial statements of Willis Lease Finance Corporation and its subsidiaries (the Company) 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 footnote 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 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 the Company's Annual Report on Form 10-K/A for the fiscal year ended December 31, 2004.

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 the financial position of the Company as of March 31, 2005, and December 31, 2004, and the results of its operations for the three month periods ended March 31, 2005 and 2004 and its cash flows for the three months ended March 31, 2005 and 2004. The results of operations and cash flows for the period ended March 31, 2005 are not necessarily indicative of the results of operations or cash flows which may be reported for the remainder of 2005.

Management considers the operations of the Company to operate in one reportable segment.

**2. Restatement**

The Company recently reviewed its financial statement presentation and disclosure in response to comments received from the staff of the Securities and Exchange Commission in a normal periodic review of the Company's filings. As a result, the Company is restating the consolidated balance sheets for March 31, 2005 and December 31, 2004, to separately classify cash that is restricted in connection with the Company's borrowings. The restricted cash was previously disclosed in narrative form and included within the description for cash and cash equivalents. The consolidated statements of cash flows for the three months ended March 31, 2005 and 2004 have been restated to reflect the impact of this change.

The changes to the Company's presentation described above do not change the Company's total assets, total liabilities, shareholders' equity, revenue or net income. All such changes have been consistently applied to all periods presented and a comparison of the amounts previously reported to the restated amounts presented in this 2005 First Quarter 10-Q/A (in thousands) are shown as follows:

| Consolidated Balance Sheet Information | March 31, 2005      |             | December 31, 2004   |             |
|--|---------------------|-------------|---------------------|-------------|
|  | As Previously Filed | As Restated | As Previously Filed | As Restated |
| Cash and cash equivalents              | \$ 41,605           | \$ 2,756    | \$ 51,864           | \$ 5,540    |
| Restricted cash                        |                     | 38,849      |                     | 46,324      |

| Consolidated Statements of Cash Flow Information | For the Three Months Ended March 31, |             |                     |             |
|--|--------------------------------------|-------------|---------------------|-------------|
|  | 2005                                 | 2005        | 2004                | 2004        |
|  | As Previously Filed                  | As Restated | As Previously Filed | As Restated |
| Changes in assets and liabilities:               |                                      |             |                     |             |
| Restricted cash                                  |                                      | 7,475       |                     | 175         |
| Net cash provided by operating activities        | 9,298                                | 16,773      | 8,343               | 8,518       |
| Decrease in cash and cash equivalents            | (10,259)                             | (2,784)     | (6,126)             | (5,951)     |
| Cash and cash equivalents at beginning of period | 51,864                               | 5,540       | 42,986              | 9,202       |
| Cash and cash equivalents at end of period:      |                                      |             |                     |             |
| Unrestricted cash and cash equivalents           | 2,756                                |             | 3,251               |             |
| Restricted cash and cash equivalents             | 38,849                               |             | 33,609              |             |
| Cash and cash equivalents at end of period       | \$ 41,605                            | \$ 2,756    | \$ 36,860           | \$ 3,251    |

### 3. 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 the Company 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, the Company evaluates its estimates, including those related to residual values, estimated asset lives, bad debts, income taxes, contingencies and litigation. The Company bases its 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 useful life of equipment, residual values and asset impairment are critical to the results of operations.

If the useful lives or residual values are lower than those estimated by the Company, upon sale of an 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.

### 4. Commitments, Contingencies, Guarantees and Indemnities

The Company has three leases for its office space. The remaining lease commitment for the Sausalito office for 2005 is approximately \$264,000. The lease expires on December 31, 2005, but has two one-year fair market value renewal options. The Company has given notice that it may

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exercise its option to extend the lease for at least one year. The remaining lease commitment for premises in San Diego is approximately \$43,000 plus expenses. The lease expires on October 31, 2005. The Company has plans to renew the lease and is in negotiations with avioserv, the landlord. The lease for premises in Shanghai, China expires in June 2005, and the Company has not yet decided whether to renew its lease in China. The remaining lease commitment is approximately \$13,000.

The Company has a number of guaranties in respect of its credit facilities. Refer to Note 5 for a full description of the nature and terms of these guaranties. Additionally, the Company generally indemnifies the purchaser of its equipment against any taxes arising from the sale of the equipment (except taxes incurred by the purchaser). The amount of the indemnification is not determinable and the Company has not had to make any payments under such indemnifications.

The Company has commitments to purchase, during 2005, engines and other engine-related equipment totaling \$6.4 million.

In July 2004, one of the Company's engines (with a net investment of \$1.9 million) was damaged while on lease to a customer. It is not possible to determine the eventual financial impact of this incident.

## 5. Investments

The Company participates in a joint venture formed as a limited company—Sichuan Snecma Aero-engine Maintenance Co. Ltd. (Sichuan Snecma). The Company's interest in the venture is 7%. Sichuan Snecma provides maintenance and repair services for CFM56 series engines and is located in Chengdu, China. Other participants in the joint venture are Air China International Company and Snecma Services. As of March 31, 2005, \$1.5 million has been invested. This investment is recorded at cost.

## 6. Notes Payable

At March 31, 2005, notes payable consists of loans totaling \$361.7 million payable over periods of three months to seven years with interest rates varying between approximately 4.5% and 8.6% (excluding the effect of the Company's interest rate hedges). The significant facilities are described below.

At March 31, 2005, the Company had a \$148.5 million revolving credit facility to finance the acquisition of aircraft engines and spare parts for lease as well as for general working capital purposes. As of March 31, 2005, \$28.5 million was available under this facility. The facility matures in May 2007. The interest rate on this facility at March 31, 2005 is one-month LIBOR plus 2.25%. Under the revolver facility, all subsidiaries except WLFC-AC1 Inc. and Willis Engine Funding LLC (WEF) jointly and severally guarantee payment and performance of the terms of the loan agreement. The maximum guarantee is \$148.5 million plus any accrued and unpaid interest, fees or reimbursements, but is limited at any given time to the sum of the principal outstanding plus interest and fees.

At March 31, 2005, the Company had a \$11.2 million term loan facility available to a wholly-owned consolidated subsidiary of the Company, WLFC-AC1 Inc., for the financing of jet aircraft engines sold by the Company to such subsidiary. The facility is a five-year term loan with final maturity of June 29, 2005. The interest rate is LIBOR plus 2.05%. As of March 31, 2005, this facility is fully drawn. The Company has guaranteed the obligations of WLFC-AC1 Inc.

At March 31, 2005, the Company had a \$209.1 million debt warehouse facility. A wholly-owned special purpose entity, WEF, was created in 2002 for the purpose of financing jet aircraft engines. The facility had a revolving period which ended March 9, 2005, followed by a four-year amortization period, during which 90% of the net rents from the collateral are used to pay down principal, followed by a final balloon payment. The facility's structure is designed to facilitate the issuance of public or private securitized notes. There is no assurance that a securitization can be completed or completed on terms that are acceptable to the Company. The facility notes are divided into \$188.2 million Class A notes and \$20.9 million Class B notes. The Company has a guaranty to the Class B Noteholders determined by a formula in the debt agreement. The maximum amount of the guaranty at March 31, 2005 is \$20.9 million. If WEF defaults on its obligations, the full amount of the Class B notes outstanding (together with any accrued interest and fees) is due and payable immediately. The governing documents of the warehouse facility and the WEF operating agreement require that the assets of WEF and any associated Owner Trust are not available to satisfy the obligations of the Company or any of its affiliates. WEF is consolidated for financial statement presentation purposes. At March 31, 2005, interest on the Class A notes is a commercial paper rate plus a weighted average spread of approximately 2.26% and interest on the Class B Notes is 1-month LIBOR plus a weighted average spread of 5.32%.



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At March 31, 2005, one-month LIBOR was 2.87% and the commercial paper rate was approximately 2.79%. At March 31, 2004, the rates were approximately 1.09% and 1.08%, respectively.

The following is a summary of the aggregate maturities of notes payable on March 31, 2005 (dollars in thousands):

**Year Ending December 31,**

|                     |    |         |
|---------------------|----|---------|
| 2005                | \$ | 31,648  |
| 2006                |    | 15,897  |
| 2007                |    | 133,383 |
| 2008                |    | 14,105  |
| 2009                |    | 161,083 |
| 2010 and thereafter |    | 5,606   |
|                     | \$ | 361,722 |

## 7. Derivative Instruments

The Company holds a number of interest rate hedges to mitigate its exposure to changes in interest rates, in particular one-month LIBOR, as 97% of the Company's borrowings are at variable rates. In addition, WEF is required under its credit agreement to hedge a portion of its borrowings. These hedges have been documented and designated as cash flow hedges under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities* (as amended). At March 31, 2005, the Company was a party to interest rate swap agreements with notional outstanding amounts of \$100.0 million, remaining terms of between 24 and 34 months and fixed rates of between 2.52% and 3.45%. The fair value of these hedges at March 31, 2005, was positive \$2.8 million and represented the estimated amount the Company would receive if it terminated the hedges. At March 31, 2005, the Company was also party to a number of interest rate caps, documented and designated as cash flow hedges. These caps have notional amounts of \$40.0 million, remaining terms of between 1 and 13 months, with rates capped at between 5.0% and 5.5%, respectively. At March 31, 2005, the fair value of the caps was approximately zero.

The Company reviews the effectiveness of its interest rate hedges on a quarterly basis and adjusts the fair value of the interest rate hedges through either Other Comprehensive Income/(Loss) and/or Earnings for the period. For the three months ended March 31, 2005 and 2004, the change in fair value of the interest rate hedges recorded to Accumulated Other Comprehensive Income/(Loss) was a gain of \$0.9 million (net of tax expense of \$0.5 million), and a loss of \$0.5 million (net of tax benefits of \$0.2 million), respectively. In both periods, there was no change in fair value recognized in earnings. Interest expense for the three months ended March 31, 2005 and 2004, was increased due to the Company's interest rate hedges by approximately \$0.1 million and \$0.5 million, respectively. A reclassification into earnings from Accumulated Other Comprehensive Income/(Loss) may occur if the effectiveness of the interest rate hedges is reduced, or they are terminated ahead of their maturity, or the Company changes the terms of its debt such that the terms of the hedges no longer match. The Company does not plan to undertake such transactions and accordingly, does not expect any reclassification into earnings within the next 12 months. Based on the estimated forward rate of LIBOR at March 31, 2005, the Company anticipates that interest expense will be decreased by approximately \$0.9 million for the 12 months ending March 31, 2006 due to its hedges.

## 8. Stock-Based Compensation Plans

The Company accounts for its two stock-based compensation plans using the intrinsic value method prescribed by APB Opinion No. 25, *Accounting for Stock Issued to Employees* and related interpretations, as allowed under SFAS No. 123, *Accounting for Stock Based Compensation* and SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure* an amendment of FASB Statement No. 123. APB 25 requires compensation expense to be recognized over the employee service period based on the excess, if any, of the quoted market price of the stock at the date the award is granted or other measurement date, as applicable, over an amount the employee must pay to acquire the stock. As a result no compensation expense has been recognized for the three months ended March 31, 2005 and 2004.

Had compensation cost for the Company's two stock-based compensation plans been determined consistent with SFAS No. 148, the Company's net income and earnings per share, determined by using the Black-Scholes option valuation method, would have been as follows:

|  | Three Months Ending March 31,<br>(dollars in thousands,<br>except per share data) |        |
|--|---|--------|
|  | 2005  | 2004   |
| Net Income as reported   | \$ 566  | \$ 969 |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effect | (133)   | (188)  |

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|   |    |      |    |      |
|---|----|------|----|------|
| Proforma net income                           | \$ | 433  | \$ | 781  |
| Basic earnings per common share as reported   | \$ | 0.06 | \$ | 0.11 |
| Basic earnings per common share pro forma     | \$ | 0.05 | \$ | 0.09 |
| Diluted earnings per common share as reported | \$ | 0.06 | \$ | 0.11 |
| Diluted earnings per common share pro forma   | \$ | 0.05 | \$ | 0.09 |

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. Because the Company's employee stock options have characteristics significantly

different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion the existing models do not necessarily provide a reliable single measure of the fair value of the Company's options.

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

### **Overview**

The Company's core business is acquiring and leasing, primarily pursuant to operating leases, commercial aircraft engines and related aircraft equipment; and the selective purchase and sale of commercial aircraft engines (collectively "equipment").

### **Critical Accounting Policies and Estimates**

The preparation of consolidated financial statements requires the Company 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, the Company evaluates its estimates, including those related to residual values, estimated asset lives, bad debts, and income taxes, contingencies and litigation. The Company bases its 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.

The Company believes the following critical accounting policies, grouped by its activities, affect its more significant judgments and estimates used in the preparation of its consolidated financial statements:

*Leasing Related Activities.* Revenue from leasing of aircraft equipment is recognized as operating lease or finance lease revenue over the terms of the applicable lease agreements. Where collection cannot be reasonably assured, for example, upon a lessee bankruptcy, the Company does not recognize revenue. The Company also estimates and charges to income a provision for bad debts based on its experience in the business and with each specific customer and the level of past due accounts. The financial condition of the Company's customers may deteriorate and result in actual losses exceeding the estimated allowances. In addition, any deterioration in the financial condition of the Company's customers may adversely affect future lease revenues. As of March 31, 2005, all of the Company's leases are accounted for as operating leases. Under an operating lease, the Company retains title to the leased equipment, thereby retaining the potential benefit and assuming the risk of the residual value of the leased equipment.

The Company generally depreciates engines on a straight-line basis over 15 years to a 55% residual value. Spare parts packages are generally depreciated on a straight-line basis over 15 years to a 25% residual value. Aircraft are generally depreciated on a straight-line basis over 13-20 years to a 15%-17% residual value. For equipment which is unlikely to be repaired at the end of its current expected life and is likely to be disassembled upon lease termination, the Company depreciates the equipment over its estimated life to a residual value based on an estimate of the wholesale value of the parts after disassembly. Currently 40 engines having a net book value of approximately \$105.5 million are

depreciated using this policy. If useful lives or residual values are lower than those estimated by the Company, upon sale of the equipment, a loss may be realized. The Company reviews these estimates regularly and a change in either of these estimates would cause an associated change in depreciation expense.

*Sales Related Activities.* For equipment sold out of the Company's lease portfolio, the Company recognizes the gain or loss associated with the sale as revenue. Gain consists of sales proceeds less the net book value of the equipment sold and any costs directly associated with the sale. Additionally, to the extent that any deposits or reserves are not included in the sale and the purchaser of the equipment assumes any liabilities associated therewith, such deposits and reserves are included in the proceeds of sale.

*Asset Valuation.* Statement of Financial Accounting Standards No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, (SFAS 144) requires that long-lived assets and certain identifiable intangibles to be held and used by an entity be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable, and long-lived assets and certain identifiable intangibles to be disposed of generally be reported at the lower of carrying amount or fair value less cost to sell. Impairment is identified by comparison of undiscounted forecast cash flows, including estimated sales proceeds, over the life of the asset with the asset's book value. If the forecast undiscounted cash flows are less than the book value the asset is written down to its fair value. Fair value is determined by reference to independent appraisals, quoted market prices (e.g. an offer to purchase) and other factors considered by Management.

For further information on these and other accounting policies adopted by the Company, refer to Note 2 of the Notes to Consolidated Financial Statements in the Company's annual report on Form 10-K for the year ended December 31, 2004.

## Results of Operations

*Three months ended March 31, 2005, compared to the three months ended March 31, 2004:*

*Leasing Related Activities.* Lease related revenue for the quarter ended March 31, 2005 increased 1.8% to \$15.0 million from \$14.8 million for the comparable period in 2004. This increase mainly reflects an increase lease rates offset by a decrease in amount of equipment on-lease. At March 31, 2005 and 2004, respectively, approximately 89% and 88% of equipment held for lease by book value were on-lease. The aggregate of net book value of leased equipment and net investment in direct finance lease at March 31, 2005 and 2004 was \$509.8 million and \$502.3 million, respectively.

During the quarter ended March 31, 2005, the Company added \$12.7 million of equipment and capitalized costs to its lease portfolio and sold three engines and other related equipment generating a net gain of \$0.7 million.

During the quarter ended March 31, 2004, the Company added \$3.5 million of equipment and capitalized costs to its lease portfolio and sold one engine generating a net gain of \$0.1 million.

*Depreciation Expense.* Depreciation expense increased 5.6% to \$6.0 million for the quarter ended March 31, 2005 from the comparable period in 2004, mainly due to changes in estimates of useful life and residual values on certain older engine types.

*Net finance costs.* Interest expense increased 28.4% to \$5.6 million for the quarter ended March 31, 2005, from the comparable period in 2004, due principally to increases in interest rates, and to a lesser extent to increased average debt outstanding. Interest income increased 258.6% to \$0.2 million for the quarter ended March 31, 2005. Interest is earned on cash and deposits held and notes receivable.

*General and Administrative Expenses.* General and administrative expenses decreased 1.2% to \$3.6 million for the quarter ended March 31, 2005, from the comparable period in 2004, mainly due to decreased employee costs and engine-related maintenance expenses, offset by increased transportation and outside technical services costs.

*Income Taxes.* Income tax expense for the quarters ended March 31, 2005 and 2004, was \$0.2 million and \$0.4 million, respectively. The effective tax rates for the quarters ended March 31, 2005 and 2004 were 28% and 29%, respectively. The change in effective tax rate was due primarily to an increase in the amount of benefit obtained under the Extraterritorial Income Exclusion as a percentage of pre-tax income.

#### **RECENT ACCOUNTING PRONOUNCEMENTS**

In December 2004, FASB issued SFAS No. 153 *Exchanges of Nonmonetary Assets* an amendment of APB Opinion No. 29 . The guidance in APB Opinion No. 29, *Accounting for Nonmonetary Transactions* , was based on the principle that exchanges of nonmonetary assets should be measured based on the fair value of the assets exchanged. The guidance in that Opinion, however, included certain exceptions to that principle. This Statement amends Opinion 29 to eliminate the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. A nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. The Company did not undertake any transaction in the three months ended March 31, 2005 that would be affected by this Statement.

In December 2004, FASB issued SFAS 123 (R) which is a revision to FASB Statement No. 123, *Accounting for Stock-Based Compensation*. This Statement also supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees* , and its related implementation guidance. The revised Statement requires a public entity to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award (with limited exceptions). That cost will be recognized over the period during which an employee is required to provide service in exchange for the award the requisite service period (usually the vesting period). No compensation cost is recognized for equity instruments for which employees do not render the requisite service. Employee share purchase plans will not result in recognition of compensation cost if certain conditions are met; those conditions are much the same as the related conditions in Statement 123. This Statement applies to all awards granted after the required effective date and to awards modified, repurchased, or cancelled after that date. The cumulative effect of initially applying this Statement, if any, is recognized as of the required effective date. The Company has an employee stock option/issuance

plan which will be affected by the implementation of this Statement. Currently, under the existing statement the Company does not

recognize compensation cost in respect of its plans and opts to make pro-forma disclosure of the impact which is described in Note 7 to its Financial Statements. In April 2005, the SEC adopted a new rule allowing companies to implement Statement No. 123(R) for fiscal years beginning after June 15, 2005.1

### **Liquidity and Capital Resources**

Historically, the Company has financed its growth through borrowings secured by its equipment lease portfolio, operating cash flow and the issuance of stock. Cash of approximately \$16.9 million and \$5.0 million, in the three-month periods ended March 31, 2005 and 2004, respectively, was derived from borrowings. Cash flow from operating activities provided \$16.8 million and \$8.5 million in the three-month periods ended March 31, 2005 and 2004, respectively. In these same time periods, \$25.0 million and \$16.8 million, respectively, of cash was used to repay debt.

The Company's primary use of net funds borrowed is for the purchase of, or repair and improvement to, equipment for lease. Approximately \$12.7 million (including capitalized costs) and \$3.5 million (including capitalized costs) of funds were used for these purposes in the three-month periods ended March 31, 2005 and 2004, respectively.

Cash flows from operations are driven significantly by payments made under the Company's lease agreements, which are comprised of lease revenue and maintenance reserves, offset by interest expense. While the Company has experienced higher lease rates, these have been offset by increases in interest rates such that the spread between lease rates and interest rates has narrowed during the three-month period ended March 31, 2005. The lease revenue stream, in the short-term, is at fixed rates while a substantial amount of the Company's debt is at variable rates. If interest rates increase it is unlikely the Company could increase lease rates in the short term and this would cause a reduction in the Company's earnings. Revenue and maintenance reserves are also affected by the amount of equipment off lease. Approximately 89%, by book value, of the Company's assets were on-lease at March 31, 2005, compared to approximately 88% at March 31, 2004, and the average utilization rate for the three months ended March 31, 2005, was 88% compared to 91% in the prior year. 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.

At March 31, 2005, notes payable consist of loans totaling \$361.7 million payable over periods of three months to seven years with interest rates varying between approximately 4.5 % and 8.6% (excluding the effect of the Company's interest rate hedges). The interest rates on the variable rate debt include one-month LIBOR at March 31, 2005 of 2.87%. The significant facilities are described below.

At March 31, 2005, the Company had a \$148.5 million revolving credit facility to finance the acquisition of aircraft engines for lease as well as for general working capital purposes. As of March 31, 2005, \$28.5 million was available under this facility. The facility matures in May 2007. The interest rate on this facility at March 31, 2005 was 1-month LIBOR plus 2.25%. Under the revolver facility, all subsidiaries except WLFC-AC1 and Willis Engine Funding LLC ( WEF ) jointly and severally guarantee payment and performance of the terms of the loan agreement. The maximum guarantee is \$148.5 million plus any accrued and unpaid interest, fees or reimbursements but is limited at any given time to the sum of the principal outstanding plus accrued interest and fees.



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At March 31, 2005, the Company had a \$209.1 million debt warehouse facility. A wholly-owned special purpose entity, WEF, was created in 2002 for the purpose of financing jet aircraft engines. The facility's revolving period ended March 9, 2005, and commenced a 4-year amortization period during which 90% of the net rents from the collateral are used to pay down principal, followed by a final balloon payment. The facility's structure is designed to facilitate the issuance of public or private securitized notes. There is no assurance that a securitization can be completed or completed on terms that are favorable or acceptable to the Company. Refer to Factors that May Affect Future Results for further discussion of the risks the Company faces. The facility notes are divided into \$188.2 million Class A notes and \$20.9 million Class B notes. The Company provides a guaranty to the Class B Noteholders. If WEF defaults on its obligations, the full amount of the Class B notes outstanding (together with any accrued interest and fees) is due and payable immediately. The governing documents of the warehouse facility and the WEF operating agreement require that the assets of WEF and any associated Owner Trust are not available to satisfy the obligations of the Company or any of its affiliates. WEF is consolidated for financial statement presentation purposes. At March 31, 2005, interest on the Class A notes is a commercial paper rate plus a weighted average spread of 2.26% and interest on the Class B Notes is 1-month LIBOR plus a weighted average spread of 5.32%.

At March 31, 2005, the Company had warehouse and revolving credit facilities totaling \$357.6 million compared to \$364.5 million at December 31, 2004. At March 31, 2005 and December 31, 2004, respectively, \$28.5 million and \$31.5 million was available under these combined facilities.

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At March 31, 2005, the Company had an \$11.2 million term loan facility available to a wholly-owned consolidated subsidiary of the Company, WLFC-AC1 Inc., for the financing of jet aircraft engines sold by the Company to such subsidiary. The facility is a five-year term loan with final maturity of June 29, 2005. The interest rate is 1-month LIBOR plus 2.05%. This facility is fully drawn. The Company has guaranteed the obligations of WLFC-AC1 under the terms of this facility.

At March 31, 2005, 1-month LIBOR was 2.87% and the commercial paper rate was 2.79%. At March 31, 2004, the rates were approximately 1.09% and 1.08%, respectively.

Approximately \$342.6 million of the above debt is subject to the Company continuing to comply 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. In addition, the Company can typically borrow 83% of an engine purchase and between 50% to 80% of an aircraft or spare parts purchase under these facilities, so the Company must have other available funds for the balance of the purchase price of any new equipment to be purchased or it will not be permitted to draw on these facilities. The facilities are also cross-defaulted. If the Company does not comply with the covenants or eligibility requirements, the Company may not be permitted to borrow additional funds and accelerated payments may become necessary. Additionally, debt is secured by engines on lease to customers and to the extent that engines are returned from lease early or are sold, repayment of that portion of the debt could be accelerated. The Company was in compliance with all covenants at March 31, 2005.

During the remainder of 2005, the Company has commitments to purchase one engine for \$6.4 million.

The Company has three leases for its office space. The remaining lease rental commitment for the Sausalito office for 2005 is approximately \$264,000. The lease expires on December 31, 2005 but has two one-year renewal options. The Company has given notice that it may exercise its option to extend the lease for at least one further year. The lease commitment for premises in San Diego is approximately \$43,000 plus expenses. The lease expires on October 31, 2005. The Company has plans to renew the lease and is in negotiations with avioserv, the landlord. The lease for premises in Shanghai, China expires in June 2005, and the Company has not yet decided whether to renew its lease in China. The remaining lease commitment is approximately \$13,000.

The Company believes its equity base, internally generated funds and existing debt facilities are sufficient to maintain the Company's level of operations through 2005. A decline in the level of internally generated funds such as could result if off-lease rates increase or a decrease in availability under the Company's existing debt facilities would impair the Company's ability to sustain its level of operations. The Company is discussing additions to its capital base with its commercial and investment banks. If the Company is not able to access additional capital, its ability to continue to grow its asset base consistent with historical trends will be impaired and its future growth limited to that which can be funded from internally generated capital.

### **Management of Interest Rate Exposure**

At March 31, 2005, \$352.5 million of the Company's borrowings were on a variable rate basis tied to one-month LIBOR or commercial paper rates. The Company's equipment leases are generally structured at fixed rental rates for specified terms. Increases in interest rates could narrow or eliminate the spread, or result in a negative spread, between the rental revenue the Company realizes under its leases and the interest rate that the Company pays under its borrowings.

To mitigate exposure to interest rate changes, the Company has entered into interest rate swap agreements, which have notional outstanding amounts of \$100.0 million, with remaining terms of between 24 and 34 months and fixed rates of between 2.52% and 3.45%. The Company has also purchased a number of interest rate caps with notional amounts totaling \$40 million, with remaining terms of between 1 and 13 months, and rates capped at between 5.0% and 5.5%.

Interest expense for the three-month period ended March 31, 2005, was increased due to the Company's interest rate hedges by approximately \$0.1 million and \$0.5 million in the comparable period in 2004. The Company will be exposed to risk in the event of non-performance of the interest rate hedge counter-parties. The Company plans to hedge additional amounts of its floating rate debt during the remainder of 2005.

#### **Related Party and Similar Transactions**

The Company occasionally sells engines to and purchases materials from avioserv, the successor to a former subsidiary of the Company and a current subsidiary of T Group America. T Group America is owned by T Group (f/k/a SR Technics Group), an entity that is related to FlightTechnics LLC, which holds 14% of the Company's common stock. No purchase or sale transactions occurred in the three months ended March 31, 2005 and 2004, respectively. The Company also leases office space from avioserv with the lease term expiring October 31, 2005. W. William Coon, Jr., a director of the Company, is a director of Flight Technics, LLC and T Group America. He is also Chairman of the Board of Directors of avioserv.

Effective September 13, 2002, the Company entered into a consulting agreement with Hans Jorg Hunziker, a former executive of Flightlease AG, a wholly owned subsidiary of SAir Group. Mr. Hunziker is a former Director of the Company having resigned from the Board on July 1, 2003. The agreement was for a one-year term ending September 13, 2003, and thereafter extended until January 2004 when it was terminated. Mr. Hunziker was to provide strategic advice and investigation into additional sources of capital in Europe.

Gavarnie Holding, LLC, a Delaware Limited Liability Company ( Gavarnie ) owned by Charles F. Willis, IV, purchased the stock of Aloha IslandAir, Inc., a Delaware Corporation, ( IslandAir ) from Aloha AirGroup, Inc. ( Aloha ) on May 11, 2004. Charles F. Willis, IV is the President, CEO and Chairman of the Board of Directors of the Company and owns approximately 34% of the Company's stock as of March 31, 2005. IslandAir leases five DeHaviland DHC-8-100 aircraft from the Company, under non-cancelable leases which generate lease revenue of approximately \$2.5 million per year and have a net book value of \$15.6 million, for remaining periods of between two and four years. IslandAir's obligations under four of these leases are guaranteed by Aloha. However, Aloha has recently filed for reorganization under Chapter 11 of the Bankruptcy Code and the Company expects Aloha's obligations under the guarantees to be discharged in this proceeding. Gavarnie is required to indemnify Aloha if a claim is made against Aloha in respect of its guarantees of IslandAir's leases from the Company. The five leases are still performing and, as of March 31, 2005, the lessee is current on all obligations and no provision has been made for any loss.

The Company entered into a Consignment Agreement dated April 30, 2004 with Avsets.com, Inc. to sell parts from a disassembled engine. J.T. Power LLC ( J.T. Power ) has agreed to market these parts on behalf of Avsets.com, Inc. and also shares office space with Avsets.com, Inc. J.T. Power is an entity whose majority shareholder, Austin Willis, is the son of the President and Chief Executive Officer of the Company, and directly and indirectly, a shareholder of the Company. The remaining book value of the parts consigned to Avsets.com is approximately \$3,000, as of March 31, 2005.

In March 2005, the Company entered into a short-term engine Lease Agreement with Sichuan Snecma Aero-Engine Maintenance Co. Ltd. at market rates. The Company holds a 7% interest in this joint venture.

### **Factors That May Affect Future Results**

Except for historical information contained herein, the discussion in this report contains forward-looking statements that involve risks and uncertainties, such as statements of the Company's plans, objectives, expectations and intentions. Forward-looking statements give the Company's expectations about the future and are not guarantees. Forward-looking statements speak only as of the date they are made, and the Company does not undertake any obligation to update them to reflect changes that occur after that date. The Company's actual results could differ materially from those discussed herein. Factors that could cause or contribute to such differences include those discussed below. The cautionary statements made in this report should be read as being applicable to all related forward-looking statements wherever they appear in this report or in other written or oral statements made by the Company.

The business in which the Company is engaged is capital intensive. Accordingly, the Company's ability to successfully execute its business strategy and to sustain its operations is dependent, in large part, on the availability of debt and equity capital. There can be no assurance that the necessary amount of capital will continue to be available to the Company on favorable terms or at all. The Company's inability to obtain sufficient capital, or to renew its credit facilities could result in increased funding costs and would limit the Company's ability to: (i) add new equipment to its portfolio, (ii) fund its working capital needs, and (iii) finance possible future acquisitions. The Company's inability to obtain sufficient capital would have a material adverse effect on the Company's business, financial condition and/or results of operations.

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The Company retains title to the equipment that it leases to third parties. Upon termination of a lease, the Company seeks to re-lease or sell the equipment. The Company also engages in the selective purchase and resale of aircraft engines. On occasion, the Company purchases engines without having a firm commitment for their lease or sale. Numerous factors, many of which are beyond the Company's control, may have an impact on the Company's ability to re-lease or sell equipment on a timely basis, including the following: (i) general market conditions, (ii) the condition of the equipment upon termination of the lease, (iii) the maintenance services performed during the lease term and, as applicable, the number of hours remaining until the next major maintenance is required, (iv) regulatory changes (particularly those imposing environmental, maintenance and other requirements on the operation of aircraft engines), (v) changes in the supply of, or demand for, or cost of aircraft engines, and (vi) technological developments. There is no assurance that the Company will be able to re-lease or sell equipment on a timely basis or on favorable terms. The failure to re-lease or sell aircraft equipment on a timely basis or on favorable terms could have a material adverse effect on the Company's business, financial condition and/or results of operations.

The Company experiences fluctuations in its operating results. Such fluctuations may be due to a number of factors, including: (i) general economic conditions, (ii) the timing of sales of engines, (iii) financial difficulties experienced by airlines, (iv) interest rates, (v) downturns in the air transportation industry, including the effect of changes in fuel prices, (vi) unanticipated early lease termination or a default by a lessee, (vii) the timing of engine acquisitions, (viii) engine marketing activities, (ix) fluctuations in market prices for the Company's assets, (x) downward pressure on lease rates, and (xi) terrorism and geo-political risks. The Company anticipates that fluctuations from period to period will continue in the future. As a result, the Company believes that comparisons to results of operations for preceding periods are not necessarily meaningful and that results of prior periods should not be relied upon as an indication of future performance.

A lessee may default in performance of its lease obligations and the Company may be unable to enforce its remedies under a lease. The Company's inability to collect receivables due under a lease or to repossess aircraft equipment in the event of a default by a lessee could have a material adverse effect on the Company's business, financial condition and/or results of operations. Various airlines have experienced financial difficulties in the recent past, certain airlines have filed for bankruptcy, and a number of such airlines have ceased operations. In the United States when a debtor seeks protection under Chapter 11 of Title 11 of the United States Code (the Bankruptcy Code), creditors are automatically stayed from enforcing their rights. In the case of United States certificated airlines, Section 1110 of the Bankruptcy Code provides certain relief to lessors of aircraft equipment. The scope of Section 1110 has been the subject of significant litigation and there is no assurance that the provisions of Section 1110 will protect the Company's investment in an aircraft, aircraft engines or parts in the event of a lessee's bankruptcy. In addition, Section 1110 does not apply to lessees located outside of the United States and applicable foreign laws may not provide comparable protection. Leases of spare parts may involve additional risks. For example, it is likely to be more difficult to recover parts in the event of a lessee default and the residual value of parts may be less ascertainable than an engine.

The Company's leases are generally structured at fixed rental rates for specified terms while a majority of the Company's borrowings are at floating rates. Increases in interest rates could narrow or eliminate the spread, or result in a negative spread, between the rental revenue the Company realizes under its leases and the interest rate the Company pays under its borrowings, and have a material adverse effect on the Company's business, financial condition and/or results of operations.

For the three months ended March 31, 2005, 82% of the Company's lease revenue was generated by leases to foreign customers. Such international leases may present greater risks to the Company because certain foreign laws, regulations and judicial procedures may not be as protective of lessor rights as those which apply in the United States. All leases require payment in United States (U.S.) dollars. If these lessees' currency devalues against the U.S. dollar, the lessees could potentially encounter difficulty in making the U.S. dollar denominated payment. The Company is also subject to the timing and access to courts and the remedies local laws impose in order to collect its lease payments and recover its assets. In addition, political instability abroad and changes in international policy also present risk of expropriation of the Company's leased engines. Furthermore, many foreign countries have currency and exchange laws regulating the international transfer of currencies which may impede or prevent payment from being made.

There is no assurance that the Company will be able to effectively manage the potential expansion of its operations, or that the Company's systems, procedures or controls will be adequate to support the Company's operations, in which event the Company's business, financial condition and/or results of operations could be adversely affected. The Company may also acquire businesses that would complement or expand the Company's existing businesses. Any acquisition or expansion made by the Company may result in one or more of the following events: (i) the incurrence of additional debt, (ii) future charges to earnings related to the impairment of goodwill and other intangible assets, (iii) difficulties in the assimilation of operations, services, products and personnel, (iv) an inability to sustain or improve historical revenue and earnings levels, (v) diversion of management's attention from ongoing business operations, and (vi) potential loss of key employees. Any of the foregoing factors could have a material adverse effect on the Company's business, financial condition and/or results of operations.

The markets for the Company's products and services are extremely competitive, and the Company faces competition from a number of sources. These include aircraft, engine and aircraft parts manufacturers, aircraft and aircraft engine lessors, and airline and aircraft service and repair companies. Certain of the Company's competitors have substantially greater resources than the Company, including greater name recognition, a

broader range of equipment, complementary lines of business and greater financial, marketing and other resources. In addition, equipment manufacturers, and other aviation aftermarket suppliers may vertically integrate into the markets that the Company serves, thereby significantly increasing industry competition. There can be no assurance that competitive pressures will not materially and adversely affect the Company's business, financial condition and/or results of operations.

The Company's leasing activities generate significant depreciation allowances that provide the Company with substantial tax benefits on an ongoing basis. In addition, the Company's lessees enjoy favorable accounting and tax treatment by entering into operating leases. The Company also benefits from the Extraterritorial Income Exclusion regulations which significantly reduce the Company's effective tax rate. As a result of recent legislation this benefit is being phased out over the next three years and the Company's effective tax rate will increase. Other changes to tax laws or accounting principles that make operating lease financing less attractive or affect the Company's recognition of revenue or expense could have a material impact on the Company's business, financial condition and/or results of operations.

As a public company, Willis Lease is subject to certain regulatory requirements including, but not limited to, compliance with Section 404 of the Sarbanes-Oxley Act of 2002. Such compliance results in significant additional costs to the Company both directly, through increased audit and consulting fees, and indirectly, through the time required by management to address the regulations. However, the SEC has recently delayed the implementation date of Section 404 for non-accelerated filers such as the Company until 2006. Such costs will likely have an adverse effect on the Company's business, financial condition and/or results of operations.

In September 2004, the Company acquired a Canadair Challenger 601-1A aircraft for general corporate purposes and for charter to third parties. The Company expects that annual ownership costs will be approximately \$1.1 million with additional operating costs depending on usage. The Company has also negotiated a management contract which should generate net charter revenues of approximately \$0.6 million per annum depending on usage that will reduce overall cost. However there can be no assurance that these revenues will be realized.

The Company obtains a substantial portion of its engines and aircraft from airlines, overhaul facilities and other suppliers. There is no organized market for engines and aircraft. The Company relies on its representatives, advertisements and its reputation in order to generate opportunities to purchase such equipment. The market for bulk sales of engines and aircraft is highly competitive, in some instances involving a bidding process. While the Company has been able to purchase engines and aircraft in this manner successfully in the past, there is no assurance that engines and aircraft will be available on acceptable terms or that the Company will continue to compete effectively in the purchase of such equipment.

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

The Company's primary market risk exposure is that of interest rate risk. A change in one-month LIBOR, or cost of funds based on commercial paper market rates, would affect the rate at which the Company borrows funds under its various borrowing facilities. Increases in interest rates to the Company, which may cause the Company to raise the implicit rates charged to its customers, could result in a reduction in demand for the Company's leases. Approximately \$352.5 million of the Company's credit facilities are variable rate debt. The Company estimates a one percent and two percent increase or decrease in the Company's variable rate debt would result in an increase or decrease (including hedges), in interest expense of \$2.5 million and \$4.9 million per annum, respectively.

The Company hedges a portion of its borrowings, effectively fixing the rate of these borrowings (refer to Management of Interest Rate Exposure for more details of the Company's hedging arrangements and Note 6 for its accounting treatment). Such hedging activities may limit the Company's ability to participate in the benefits of any decrease in interest rates, but may also protect the Company from increases in interest rates. Other financial assets and liabilities are at fixed rates.

The Company is also exposed to currency devaluation risk. During the three-month period ended March 31, 2005, 82% of the Company's total lease revenues came from non-United States domiciled lessees. All of the leases require payment in United States (U.S.) dollars. If these lessees' currency devalues against the U.S. dollar, the lessees could potentially encounter difficulty in making the U.S. dollar denominated lease



payments.

**Item 4. Controls and Procedures**

(a) *Evaluation of disclosure controls and procedures.* As of May 16, 2005, at the time of the original filing of the Company's Form 10-Q for the quarter ended March 31, 2005, the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures pursuant to Exchange Act Rule 13a-15c. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective in alerting them, on a timely basis, to material information relating to the Company (including its consolidated subsidiaries) required to be included in the Company's periodic reports.

On July 13, 2005, the Company announced that it was restating its consolidated balance sheets, statements of income and statements of cash flows for years ended December 31, 2004, 2003 and 2002. As a result of a normal periodic review of the financial reports of the Company by the Staff of the SEC and discussions with the Staff of the SEC, the Company concluded that the net gain on debt prepayment in 2002 should be presented as an expense and cash that is restricted in connection with the Company's borrowings should be presented separately as restricted cash. In accordance with APB Opinion No. 20, paragraphs 36 and 37, the Company has reflected such changes in its restated consolidated balance sheets, consolidated statements of income and consolidated statements of cash flows as of and for the years ended December 31, 2004, 2003 and 2002 presented in the amended Annual Report on Form 10-K/A. Please refer to Note 1(l) and 2 to the accompanying consolidated financial statements for additional information.

The Company also concluded that the inclusion of restricted cash in the line items on the balance sheet, cash and cash equivalents had not been routinely reviewed for appropriateness. Even though the amounts were disclosed in the description of the line item, they should have been classified as a separate line item.

As a result of the restatement of its consolidated balance sheets, statements of income and statements of cash flows, the Company, including the Company's Chief Executive Officer and Chief Financial Officer determined that there was a material weakness in its internal control over financial reporting as of December 31, 2004 related to the presentation on its statement of income for the year ended December 31, 2002 for the net gain on debt prepayment and on its balance sheets and statements of cash flows for years ended December 31, 2004, 2003 and 2002 for cash that is restricted in connection with the Company's borrowings. The Company's Chief Executive Officer and Chief Financial Officer determined that the disclosure controls and procedures as of the end of the period were not effective. To prevent future misstatements of a similar nature, the Company changed the internal control over financial reporting by implementing expanded procedures including completion of a financial reporting checklist to ensure compliance with current reporting standards and accounting pronouncements issued since the end of the previous reporting period.

(b) *Changes in internal controls.* During the quarter ended March 31, 2005, there were no other changes in the Company's internal controls or in other factors that could affect the controls since the date of the last evaluation of internal controls as reported in the Form 10-K/A for the quarter ended December 31, 2004.

PART II - OTHER INFORMATION

**Item 6. Exhibits and Reports on Form 8-K**

(a) Exhibits

**EXHIBITS**

| <b>Exhibit Number</b> | <b>Description</b>  |
|-----------------------|---|
| 3.1                   | Certificate of Incorporation, filed on March 12, 1998 together with Certificate of Amendment of Certificate of Incorporation filed on May 6, 1998. Incorporated by reference to Exhibits 4.01 and 4.02 of the Company's report on Form 8-K filed on June 23, 1998.                  |
| 3.2                   | Bylaws, as amended. Incorporated by reference to Exhibit 3.2 of the Company's report in Form 10-K for the year ended December 31, 2004.   |
| 3.3                   | Amendment to Bylaws of Willis Lease Finance Corporation dated November 13, 2001. Incorporated by reference to Exhibit 3.3 of the Company's report in Form 10-K for the year ended December 31, 2004.  |
| 4.1                   | Specimen of Common Stock Certificate. Incorporated by reference to Exhibit 4.1 of the Company's report on Form 10-Q for the quarter ended June 30, 1998.  |
| 4.2                   | Rights Agreement dated September 24, 1999, by and between the Company and American Stock Transfer and Trust Company, as Rights Agent. Incorporated by reference to Exhibit 4.1 of the Company's report on Form 8-K filed on October 4, 1999.  |
| 4.3                   | First Amendment to Rights Agreement, dated as of November 30, 2000, by and between the Company and American Stock Transfer and Trust Company. Incorporated by reference to Exhibit 10.1 of the Company's report on Form 8-K filed December 15, 2000.                                |
| 10.1                  | Form of Indemnification Agreement entered into between the Company and its directors and officers. Incorporated by reference to Exhibit 10.3 to Registration Statement No. 333-5126-LA filed on June 21, 1996.  |
| 10.2                  | Employment Agreement between the Company and Charles F. Willis IV dated November 7, 2000. Incorporated by reference to Exhibit 10.2 of the Company's report on Form 10-K for the year ended December 31, 2000.  |
| 10.3                  | Employment Agreement between the Company and Donald A. Nunemaker dated November 21, 2000. Incorporated by reference to Exhibit 10.3 of the Company's report on Form 10-K for the year ended December 31, 2000.  |
| 10.4                  | Employment contract between the Company and Monica J. Burke dated June 21, 2002. Incorporated by reference to Exhibit 10.5 to the Company's report on Form 10-Q for the quarter ended June 30, 2002.  |
| 10.5                  | The Company's 1996 Stock Option/Stock Issuance Plan, as amended and restated as of May 22, 2001. Incorporated by reference to the Company's Proxy Statement dated May 1, 2001.  |
| 10.6                  | Stockholders' Agreement, dated as of November 7, 2000, by and among the Company, Charles F. Willis, IV, CFW Partners, L.P., Austin Chandler Willis 1995 Irrevocable Trust and FlightTechnics LLC. Incorporated by reference to Exhibit 10.8 on Form 8-K filed on November 13, 2000. |

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- 10.7\* Credit Agreement dated May 1, 2001 among the Company, certain banking institutions, National City Bank and Fortis Bank (Nederland) N.V. Incorporated by reference to Exhibit 10.24 of the Company's report on Form 10-Q for the quarter ended June 30, 2001.
- 10.8\* Amended and Restated Eighth Amendment to Amended and Restated Series 1997-1 Supplement among WLFC Funding Corporation and the Bank of New York, dated May 3, 2002. Incorporated by reference to Exhibit 10.23 to the Company's report on Form 10-Q for the quarter ended June 30, 2002

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- 10.9 Eighth Amendment to the Note Purchase Agreement, dated as of May 3, 2002, by and among the Company, WLFC Funding Corporation and Variable Funding Capital Corporation. Incorporated by reference to Exhibit 10.24 to the Company's report on Form 10-Q for the quarter ended June 30, 2002.
- 10.10\* Contribution and Sale Agreement between the Company and Willis Engine Funding LLC dated as of September 12, 2002. Incorporated by reference to Exhibit 10.25 to the Company's report on Form 10-Q for the quarter ended September 30, 2002.
- 10.11\* Series 2002-1 Supplement dated September 12, 2002 to Indenture between Willis Engine Funding LLC and The Bank of New York, Indenture Trustee. Incorporated by reference to Exhibit 10.26 to the Company's report on Form 10-Q for the quarter ended September 30, 2002.
- 10.12 Guaranty between the Company, Barclays Bank PLC and Fortis Bank (Nederland) N.V. dated as of September 12, 2002. Incorporated by reference to Exhibit 10.27 to the Company's report on Form 10-Q for the quarter ended September 30, 2002.
- 10.13\* Administration Agreement among Willis Engine Funding LLC, the Company, Barclays Bank PLC, and The Bank of New York, dated as of September 12, 2002. Incorporated by reference to Exhibit 10.28 to the Company's report on Form 10-Q for the quarter ended September 30, 2002.
- 10.14 Class A Note Purchase Agreement among Willis Engine Funding LLC, the Company, Sheffield Receivables Corporation and Barclays Bank PLC dated as of September 12, 2002. Incorporated by reference to Exhibit 10.29 to the Company's report on Form 10-Q for the quarter ended September 30, 2002.
- 10.15 Class B Note Purchase Agreement among Willis Engine Funding LLC, the Company, Fortis Bank (Nederland) N.V., and Barclays Bank PLC dated as of September 12, 2002. Incorporated by reference to Exhibit 10.30 to the Company's report on Form 10-Q for the quarter ended September 30, 2002.
- 10.16 Indenture Agreement between Willis Engine Funding LLC and The Bank of New York dated as of September 12, 2002. Incorporated by reference to Exhibit 10.31 to the Company's report on Form 10-Q for the quarter ended September 30, 2002.
- 10.17 Custodial Agreement by and among BNY Midwest Trust Company, Willis Engine Funding LLC, the Company, The Bank of New York and Barclays Bank PLC dated as of September 12, 2002. Incorporated by reference to Exhibit 10.32 to the Company's report on Form 10-Q for the quarter ended September 30, 2002.
- 10.18 Servicing Agreement between the Company and Willis Engine Funding LLC dated as of September 12, 2002. Incorporated by reference to Exhibit 10.33 to the Company's report on Form 10-Q for the quarter ended September 30, 2002.
- 10.19 Independent Contractor Agreement between the Company and Hans Joerg Hunziker dated September 13, 2002. Incorporated by reference to Exhibit 10.34 to the Company's report on Form 10-Q for the quarter ended September 30, 2002.
- 10.20 Amendment No. 2 to Credit Agreement among the Company, certain banking institutions, National City Bank and Fortis Bank (Nederland) N.V. dated as of November 13, 2002. Incorporated by reference to Exhibit 10.36 to the Company's report on Form 10-Q for the quarter ended September 30, 2002.
- 10.21\* Amended and Restated Contribution and Sale Agreement between the Company and Willis Engine Funding LLC dated as of December 13, 2002. Incorporated by reference to Exhibit 10.27 to the Company's report on Form 10-K for the year ended December 31, 2002.
- 10.22\* Amended and Restated Series 2002-1 Supplement between Willis Engine Funding LLC and The Bank of New York dated as of December 13, 2002. Incorporated by reference to Exhibit 10.28 to the Company's report on Form 10-K for the year ended December 31, 2002.

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- 10.23 Amended and Restated Guaranty between the Company, Barclays Bank PLC and Fortis Bank (Nederland) N.V. dated as of December 13, 2002. Incorporated by reference to Exhibit 10.29 to the Company's report on Form 10-K for the year ended December 31, 2002.
- 10.24\* Amended and Restated Administration Agreement among Willis Engine Funding LLC, the Company, Barclays Bank PLC and The Bank of New York dated as of December 13, 2002. Incorporated by reference to Exhibit 10.30 to the Company's report on Form 10-K for the year ended December 31, 2002.
- 10.25 Amended and Restated Subclass A-1 Note Purchase Agreement among Willis Engine Funding LLC, the Company, Sheffield Receivables Corporation and Barclays Bank PLC dated as of December 13, 2002. Incorporated by reference to Exhibit 10.31 to the Company's report on Form 10-K for the year ended December 31, 2002.
- 10.26 Subclass A-2 Note Purchase Agreement among Willis Engine Funding LLC, the Company, Sheffield Receivables Corporation and Barclays Bank PLC dated as of December 13, 2002. Incorporated by reference to Exhibit 10.32 to the Company's report on Form 10-K for the year ended December 31, 2002.
- 10.27 Amended and Restated Subclass B-1 Note Purchase Agreement among Willis Engine Funding LLC, the Company, Fortis Bank (Nederland) N.V. and Barclays Bank PLC dated as of December 13, 2002. Incorporated by reference to Exhibit 10.33 to the Company's report on Form 10-K for the year ended December 31, 2002.
- 10.28 Subclass B-2 Note Purchase Agreement among Willis Engine Funding LLC, the Company and Barclays Bank PLC dated as of December 13, 2002. Incorporated by reference to Exhibit 10.34 to the Company's report on Form 10-K for the year ended December 31, 2002.
- 10.29 Amended and Restated Indenture between Willis Engine Funding LLC, and The Bank of New York dated as of December 13, 2002. Incorporated by reference to Exhibit 10.35 to the Company's report on Form 10-K for the year ended December 31, 2002.
- 10.30 Amended and Restated Servicing Agreement between the Company and Willis Engine Funding LLC dated as of December 13, 2002. Incorporated by reference to Exhibit 10.36 to the Company's report on Form 10-K for the year ended December 31, 2002.
- 10.31\* First Supplemental Indenture between Willis Engine Funding LLC and the Bank of New York dated October 10, 2003. Incorporated by reference to Exhibit 10.33 to the Company's report on Form 10-Q for the quarter ended September 30, 2003.
- 10.32\* First Amendment to Series Supplement between Willis Engine Funding LLC and the Bank of New York dated October 10, 2003. Incorporated by reference to Exhibit 10.34 to the Company's report on Form 10-Q for the quarter ended September 30, 2003.
- 10.33 Amendment No. 1 to Note Purchase Agreements between Willis Lease Finance Corporation, Willis Engine Funding LLC, Sheffield Receivables Corporation, Fortis Bank (Nederland) N.V., and Barclays Bank plc dated October 10, 2003. Incorporated by reference to Exhibit 10.35 to the Company's report on Form 10-Q for the quarter ended September 30, 2003.
- 10.34 The Company's 1996 Stock Option/Stock Issuance Plan, as amended and restated as of March 31, 2003. Incorporated by reference to Exhibit 99.1 of the Company's Form S-8 filed on September 26, 2003.
- 10.35 Employment letter between the Company and Thomas C. Nord dated June 11, 2003. Incorporated by reference to Exhibit 10.38 to the Company's report on Form 10-K for the year ended December 31, 2003.
- 10.36\* Amended and Restated Credit Agreement, dated as of June 29, 2004 among Willis Lease Finance Corporation, and Certain Banking Institutions Named Herein with National City Bank and Fortis Bank (Nederland) N.V. Incorporated by reference to Exhibit 10.39 of the Company's Form 10-Q for the quarter ended June 30, 2004.

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- 10.37 The Company's Employee Stock Purchase Plan As Amended and Restated Effective August 1, 2004. Incorporated by reference to Exhibit 99.1 of the Company's Form S-8 filed on August 11, 2004.
- 10.38 First Amendment to Amended and Restated Credit Agreement dated as of September 23, 2004 among the Company, National City Bank, Fortis Bank (Nederland) N.V. and CDC Finance CDC IXIS. Incorporated by reference to Exhibit 10.41 of the Company's Form 10-Q for the quarter ended September 30, 2004.
- 10.39 Letter Agreement dated September 30, 2004 between the Company, Willis Engine Funding LLC, The Bank of New York, Sheffield Receivables Corporation, Barclays Bank PLC and Fortis Bank (Nederland) N.V. to extend the Company's warehouse facility. Incorporated by reference to Exhibit 10.42 of the Company's Form 10-Q for the quarter ended September 30, 2004.
- 10.40 Loan and Aircraft Security Agreement dated October 29, 2004 between Fleet Capital Corporation and Willis Lease Finance Corporation. Incorporated by reference to Exhibit 10.42 of the Company's report in Form 10-K for the year ended December 31, 2004.
- 10.41 Second Amendment to Amended and Restated Credit Agreement dated as of December 9, 2004 among Willis Lease Finance Corporation, National City Bank, Certain Named Banking Institutions and Fortis Bank (Nederland) N.V. Incorporated by reference to Exhibit 10.43 of the Company's report in Form 10-K for the year ended December 31, 2004.
- 10.42 Amendment No. 1 to Loan and Aircraft Security Agreement dated as of December 9, 2004 between Fleet Capital Corporation and Willis Lease Finance Corporation. Incorporated by reference to Exhibit 10.44 of the Company's report in Form 10-K for the year ended December 31, 2004.
- 10.43 The Company's Deferred Compensation Plan Effective as of July 1, 2001. Incorporated by reference to Exhibit 10.45 of the Company's Form 10-K/A for the year ended December 31, 2004.
- 11.1 Statement regarding computation of per share earnings.
- 31.1 Certification of Charles F. Willis, IV pursuant to Section 1350 as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Monica J. Burke pursuant to Section 1350 as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32 Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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\* Portions of these exhibits have been omitted pursuant to a request for confidential treatment and the redacted material has been filed separately with the Commission.

### (b) Reports on Form 8-K

On March 25, 2005, the Company filed a form 8-K disclosing under Item 7, Financial Statements, Pro-forma Financial Information and Exhibits and Item 12, Results of Operations and Financial Condition, its Press Release on Earnings for the three and twelve months ended December 31, 2004.

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: July 27, 2005

Willis Lease Finance Corporation

By: **/s/ Monica J. Burke**  
Monica J. Burke  
Chief Financial Officer

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