Air Transport Services Group, Inc.
Form 10-Q
November 02, 2018

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2018
o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from ________ to ________

Commission file number 000-50368

(Exact name of registrant as specified in its charter)

Delaware	26-1631624
(State of Incorporation)	(I.R.S. Employer Identification No.)
145 Hunter Drive, Wilmington, OH	45177
(Address of Principal Executive Offices)	(Zip Code)

937-382-5591
(Registrant's telephone number, including area code)

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 x NO o
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulations S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES x NO o
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer x	Accelerated filer o
Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o
Emerging growth company o	

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 7(a)(2)(B) of the Securities Act. o
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). YES o NO x
As of November 2, 2018, 59,080,387 shares of the registrant's common stock, par value $0.01, were outstanding.

AIR TRANSPORT SERVICES GROUP, INC. AND SUBSIDIARIES
FORM 10-Q
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FILINGS WITH THE SECURITIES AND EXCHANGE COMMISSION

The financial information, including the financial statements, included in the Quarterly Report on Form 10-Q should be read in conjunction with the Company's audited consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2017, filed with the Securities and Exchange Commission on March 1, 2018.

The Securities and Exchange Commission maintains an Internet site that contains reports, proxy and information statements and other information regarding Air Transport Services Group, Inc. at www.sec.gov. Additionally, our filings with the Securities and Exchange Commission, including annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to these reports, are available free of charge from our website at www.atsginc.com as soon as reasonably practicable after filing with the SEC.

FORWARD LOOKING STATEMENTS

Statements contained in this Quarterly report on Form 10-Q that are not historical facts are considered forward-looking statements (as that term is defined in the Private Securities Litigation Reform Act of 1995). Words such as “future,” “anticipates,” “believes,” “estimates,” “expects,” “intends,” “plans,” “predicts,” “will,” “would,” “could,” “ca similar terms and expressions are intended to identify forward-looking statements. These forward-looking statements are based on expectations, estimates and projections as of the date of this filing, and involve risks and uncertainties that are inherently difficult to predict. Actual results may differ materially from those expressed in the forward-looking statements for any number of reasons, including those described in this report and in our 2017 Annual Report filed on Form 10-K with the Securities and Exchange Commission.

PART I. FINANCIAL INFORMATION
Item 1. Financial Statements
AIR TRANSPORT SERVICES GROUP, INC. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
REVENUES	$204,919	$254,101	$611,566	$745,229
OPERATING EXPENSES				
Salaries, wages and benefits	71,341	61,177	216,173	199,496
Depreciation and amortization	43,201	37,605	124,825	111,828
Maintenance, materials and repairs	33,469	33,100	107,152	100,970
Fuel	5,981	34,035	17,682	101,134
Contracted ground and aviation services	2,636	40,445	7,464	93,283
Travel	6,903	6,357	20,823	20,543
Landing and ramp	1,211	4,682	3,670	14,338
Rent	3,274	3,052	10,264	10,091
Insurance	1,696	1,234	4,473	3,451
Other operating expenses	8,380	7,962	20,672	24,588
	178,092	229,649	533,198	679,722
OPERATING INCOME	26,827	24,452	78,368	65,507
OTHER INCOME (EXPENSE)				
Interest income	67	37	144	85
Non-service component of retiree benefit costs	2,045	(5,529)	6,135	(5,883)
Net gain (loss) on financial instruments	17,895	(34,433)	28,707	(100,213)
Loss from non-consolidated affiliate	(2,647)	(945)	(7,600)	(945)
Interest expense	(5,608)	(4,351)	(16,336)	(11,658)
	11,752	(45,221)	11,050	(118,614)
EARNINGS (LOSS) FROM CONTINUING OPERATIONS BEFORE INCOME TAXES	38,579	(20,769)	89,418	(53,107)
INCOME TAX EXPENSE	(5,646)	(7,460)	(16,339)	(19,244)
EARNINGS (LOSS) FROM CONTINUING OPERATIONS	32,933	(28,229)	73,079	(72,351)
EARNINGS (LOSS) FROM DISCONTINUED OPERATIONS, NET OF TAXES	170	(4,655)	536	(4,271)
NET EARNINGS (LOSS)	$33,103	$(32,884)	$73,615	$(76,622)
BASIC EARNINGS (LOSS) PER SHARE				
Continuing operations	$0.56	$(0.48)	$1.24	$(1.23)
Discontinued operations	—	(0.08)	0.01	(0.07)
TOTAL BASIC EARNINGS (LOSS) PER SHARE	$0.56	$(0.56)	$1.25	$(1.30)
DILUTED EARNINGS (LOSS) PER SHARE				
Continuing operations	$0.24	$(0.48)	$0.71	$(1.23)
Discontinued operations	—	(0.08)	0.01	(0.07)
TOTAL DILUTED EARNINGS (LOSS) PER SHARE	$0.24	$(0.56)	$0.72	$(1.30)
WEIGHTED AVERAGE SHARES				
Basic	58,739	58,733	58,773	58,965

Diluted	68,323	58,733	68,629	58,965

See notes to condensed consolidated financial statements.

AIR TRANSPORT SERVICES GROUP, INC. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(In thousands)

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2018	2017	2018	2017
NET EARNINGS (LOSS)	$33,103	$(32,884)	$73,615	$(76,622)
OTHER COMPREHENSIVE INCOME (LOSS):				
Defined Benefit Pension	687	5,763	2,061	8,232
Defined Benefit Post-Retirement	43	37	127	111
Foreign Currency Translation	22	(15)	(117)	121
TOTAL COMPREHENSIVE INCOME (LOSS), net of tax	$33,855	$(27,099)	$75,686	$(68,158)

See notes to condensed consolidated financial statements.

AIR TRANSPORT SERVICES GROUP, INC. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except share data)

	September 30, 2018	December 31, 2017
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 43,462	$ 32,699
Accounts receivable, net of allowance of $1,014 in 2018 and $2,445 in 2017	93,662	109,114
Inventory	24,412	22,169
Prepaid supplies and other	15,698	20,521
TOTAL CURRENT ASSETS	177,234	184,503
Property and equipment, net	1,226,500	1,159,962
Lease incentive	68,006	80,684
Goodwill and acquired intangibles	43,710	44,577
Convertible note hedges	—	53,683
Other assets	37,618	25,435
TOTAL ASSETS	$ 1,553,068	$ 1,548,844
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$ 101,205	$ 99,728
Accrued salaries, wages and benefits	31,416	40,127
Accrued expenses	11,387	10,455
Current portion of debt obligations	14,860	18,512
Unearned revenue	15,204	15,850
TOTAL CURRENT LIABILITIES	174,072	184,672
Long term debt	527,226	497,246
Convertible note obligations	—	54,359
Stock warrant obligations	186,093	211,136
Post-retirement obligations	29,355	61,355
Other liabilities	46,334	45,353
Deferred income taxes	119,289	99,444
TOTAL LIABILITIES	1,082,369	1,153,565
Commitments and contingencies (Note H)		
STOCKHOLDERS' EQUITY:		
Preferred stock, 20,000,000 shares authorized, including 75,000 Series A Junior Participating Preferred Stock	—	—
Common stock, par value $0.01 per share; 110,000,000 shares authorized; 59,080,387 and 59,057,195 shares issued and outstanding in 2018 and 2017, respectively	591	591
Additional paid-in capital	470,676	471,456
Retained earnings (accumulated deficit)	60,381	(13,748)
Accumulated other comprehensive loss	(60,949)	(63,020)
TOTAL STOCKHOLDERS' EQUITY	470,699	395,279
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 1,553,068	$ 1,548,844

See notes to condensed consolidated financial statements.

AIR TRANSPORT SERVICES GROUP, INC. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)

	Nine Months Ended September 30	
	2018	2017
OPERATING ACTIVITIES:		
Net earnings (loss) from continuing operations	$73,079	$(72,351)
Net earnings (loss) from discontinued operations	536	(4,271)
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation and amortization	143,471	121,589
Pension and post-retirement	2,826	18,916
Deferred income taxes	15,972	15,986
Amortization of stock-based compensation	3,568	2,648
Net (gain) loss on financial instruments	(28,707)	100,213
Changes in assets and liabilities:		
Accounts receivable	18,159	11,770
Inventory and prepaid supplies	477	(2,661)
Accounts payable	1,097	11,698
Unearned revenue	(1,412)	6,995
Accrued expenses, salaries, wages, benefits and other liabilities	(4,618)	(7,357)
Pension and post-retirement assets	(32,000)	(10,658)
Other	8,365	(1,244)
NET CASH PROVIDED BY OPERATING ACTIVITIES	200,813	191,273
INVESTING ACTIVITIES:		
Capital expenditures	(214,025)	(218,759)
Proceeds from property and equipment	17,473	9
Acquisitions and investments in businesses	(8,285)	(6,900)
Redemption of long term deposits	—	9,975
NET CASH (USED IN) INVESTING ACTIVITIES	(204,837)	(215,675)
FINANCING ACTIVITIES:		
Principal payments on long term obligations	(39,889)	(250,131)
Proceeds from borrowings	60,000	90,000
Proceeds from convertible notes	—	258,750
Payments for financing costs	(414)	(6,469)
Purchase convertible note hedges	—	(56,097)
Proceeds from issuance of warrants	—	38,502
Purchase of common stock	(3,581)	(11,184)
Withholding taxes paid for conversion of employee stock awards	(1,329)	(1,436)
NET CASH PROVIDED BY FINANCING ACTIVITIES	14,787	61,935
NET INCREASE IN CASH AND CASH EQUIVALENTS	10,763	37,533
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	32,699	16,358
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$43,462	$53,891
SUPPLEMENTAL CASH FLOW INFORMATION:		
Interest paid, net of amount capitalized	$9,087	$11,229
Federal alternative minimum and state income taxes paid	$1,212	$1,285
SUPPLEMENTAL NON-CASH INFORMATION:		
Accrued capital expenditures	$23,775	$12,561

See notes to condensed consolidated financial statements.

AIR TRANSPORT SERVICES GROUP, INC. AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE A—SUMMARY OF FINANCIAL STATEMENT PREPARATION AND SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations

Air Transport Services Group, Inc. is a holding company whose subsidiaries primarily operate within the airfreight and logistics industry. The Company leases aircraft and provides airline operations, ground services, aircraft modification and maintenance services and other support services. The Company's subsidiaries offer a range of complementary services to delivery companies, freight forwarders, airlines and government customers.

The Company's leasing subsidiary, Cargo Aircraft Management, Inc. (“CAM”), leases aircraft to each of the Company's airlines as well as to non-affiliated airlines and other lessees. The airlines, ABX Air, Inc. (“ABX”) and Air Transport International, Inc. (“ATI”), each have the authority, through their separate U.S. Department of Transportation ("DOT") and Federal Aviation Administration ("FAA") certificates, to transport cargo worldwide. The Company's airlines provide a combination of aircraft, crews, maintenance and insurance services for a customer's transportation network through "CMI" and "ACMI" agreements and through charter contracts in which aviation fuel is also included. ATI provides passenger transportation, primarily to the U.S. Military, using "combi" aircraft, which are certified to carry passengers as well as cargo on the main deck. Through its subsidiary Airborne Maintenance and Engineering Services, Inc. ("AMES"), the Company provides aircraft maintenance and modification services. In addition, the Company provides ground equipment maintenance and operates mail and package sorting facilities.

Basis of Presentation

The accompanying unaudited condensed interim consolidated financial statements are prepared in conformity with accounting principles generally accepted in the United States of America and such principles are applied on a basis consistent with the financial statements reflected in our Annual Report on Form 10-K for the fiscal year ended December 31, 2017 filed with the Securities and Exchange Commission (“SEC”). 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 pursuant to the rules and regulations promulgated by the SEC related to interim financial statements. In the opinion of management, the accompanying financial statements contain all adjustments, including normal recurring adjustments, necessary for the fair presentation of the Company’s results of operations and financial position for the periods presented. Due to seasonal fluctuations, among other factors common to the air cargo industry, the results of operations for the periods presented are not necessarily indicative of the results of operations to be expected for the entire year or any interim period. The preparation of consolidated financial statements requires management to make estimates and assumptions that affect amounts reported in the consolidated financial statements. The accounting estimates reflect the best judgment of management, but actual results could differ materially from those estimates.

The accompanying condensed consolidated financial statements include the accounts of Air Transport Services Group, Inc. and its wholly-owned subsidiaries. Investments in affiliates in which the Company has significant influence but does not exercise control are accounted for using the equity method of accounting. Using the equity method, the Company’s share of the nonconsolidated affiliates' income or loss is recognized in the consolidated statement of earnings and cumulative post-acquisition changes in the investment are adjusted against the carrying amount of the investment. Inter-company balances and transactions are eliminated.

Accounting Standards Updates

Effective January 1, 2018 the Company adopted the Financial Accounting Standards Board's ("FASB") Accounting Standards Update ("ASU") No. 2014-09, “Revenue from Contracts with Customers (Topic 606)” ("Topic 606”) which superseded previous revenue recognition guidance. Topic 606 is a comprehensive new revenue recognition model that requires a company to recognize revenue to depict the transfer of goods or services to a customer at an amount that reflects the consideration it expects to receive in exchange for those goods or services. The Company's lease revenues within the scope of ASC 840, Leases, are specifically excluded from Topic 606.

The Company adopted the standard using a modified retrospective approach, under which financial statements are prepared under the revised guidance for the year of adoption, but not for prior years. Under this method, entities recognize a cumulative catch-up adjustment to the opening balance of retained earnings at the effective date for open contract performance at that time. The Company's adoption efforts included the identification of revenue within the scope of the standard, the evaluation of customer contracts in conjunction with new guidance and an assessment of the qualitative and quantitative impacts of the new standard on its financial statements. The evaluation included the application of each of the five steps identified in the Topic 606 revenue recognition model.

The Company determined that under Topic 606, it is an agent for aviation fuel and certain other costs reimbursed by customers under its ACMI and CMI contracts and for certain cargo handling services that it arranges for a customer. Under the new revenue standard, such reimbursed amounts are reported net of the corresponding expenses beginning in 2018. This application of Topic 606 did not have a material impact on the Company's reported earnings in any period. Additionally under Topic 606, the Company is required to record revenue over time, instead of at the time of completion, for certain customer contracts for airframe and modification services that do not have an alternative use and for which the Company has an enforceable right to payment during the service cycle. The Company adopted the provisions of this new standard using the modified retrospective method which requires the Company to record a one time adjustment to retained deficit for the cumulative effect that the standard has on open contracts at the time of adoption. Upon adoption of the new standard the Company accelerated $3.6 million of revenue resulting in an immaterial adjustment to its January 1, 2018 retained deficit for open airframe and modification services contracts.

In January 2017, the FASB issued ASU "Intangibles-Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment" (“ASU 2017-04”). This new standard eliminates Step 2 from the goodwill impairment test and requires an entity to perform its goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An entity recognizes an impairment charge for the amount by which the carrying amount exceeds the reporting unit’s fair value. ASU 2017-04 is effective for any annual or interim goodwill impairment tests in the fiscal years beginning after December 15, 2019 and must be applied prospectively. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. The Company adopted this new accounting guidance in January of 2018. The adoption did not have an impact on the Company's financial position, results of operations, or cash flows.

In March 2017, the FASB issued ASU "Compensation - Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost "(ASU 2017-07"). ASU 2017-07 requires an employer to report the service cost component of retiree benefits in the same line item or items as other compensation costs arising from services rendered by the pertinent employees during the period. The other components of net benefit cost are required to be presented separately from the service cost component and outside a subtotal of income from operations. The Company adopted ASU 2017-07 on January 1, 2018, retrospectively to all periods presented. As a result, retiree benefit plan interest expense, investment returns, settlements and other non-service cost components of retiree benefit expenses are excluded from the Company's operating income subtotal as reported in the Company's Consolidated Statement of Operations, but remain included in earnings before income taxes. Information about retiree benefit plans' interest expense, investment returns and other components of retiree benefit expenses can be found in Note I.

In February 2016, the FASB issued ASU "Leases (Topic 842)" ("ASU 2016-02"), which will require the recognition of right to-use-assets and lease liabilities for leases previously classified as operating leases by lessees. The standard will take effect for annual reporting periods beginning after December 15, 2018, including interim reporting periods. Early application will be permitted for all entities. In addition, the FASB has decided to require a lessee to apply a modified retrospective transition approach for capital and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements (the date of initial application). The modified retrospective approach would not require any transition accounting for leases that expired before the date of initial application. The Company is currently evaluating the impact of the standard on its financial statements and disclosures.

In February 2018, the FASB issued ASU “Reclassification of Certain Tax Effects From Accumulated Other Comprehensive Income" ("ASU 2018-02"). ASU 2018-02 amends ASC 220, Income Statement — Reporting Comprehensive Income, to allow a reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from U.S. federal tax legislation known as the Tax Cuts and Jobs Act. In addition, under the ASU 2018-02, a Company will be required to provide certain disclosures regarding stranded tax effects. ASU 2018-02 is effective for years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted. The Company is currently evaluating the impact of the standard on its financial statements and disclosures.

In June 2018, the FASB issued ASU “Improvements to Non-employee Share-based Payment Accounting" ("ASU 2018-07"). ASU 2018-07 amends ASC 718, "Compensation - Stock Compensation" ("ASC 718"), to simplify the accounting for share-based payments granted to non-employees for goods and services. ASU 2018-07 supersedes ASC 505-50, "Equity-Based Payments to Non-employees" ("ASC 505-50"). ASU 2018-07 aligns much of the accounting for share-based payments granted to non-employees for goods and services with the accounting for share-based payments granted to employees. ASU 2018-07 is effective for years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted. Companies will apply the new guidance to equity-classified non-employee awards for which a measurement date has not been established and liability-classified non-employee awards that have not been settled as of the date of adoption by recognizing a cumulative-effect adjustment to retained earnings as of the beginning of the annual period of adoption. The Company is currently evaluating the impact of the standard on its financial statements and disclosures.

NOTE B—SIGNIFICANT CUSTOMERS

DHL

The Company has had long term contracts with DHL Network Operations (USA), Inc. and its affiliates ("DHL") since August 2003. Revenues from aircraft leases and related services performed for DHL were approximately 27% and 27% of the Company's consolidated revenues from continuing operations for the three and nine month periods ending September 30, 2018, respectively, compared to 25% and 25% for the corresponding periods of 2017. Revenues excluding directly reimbursed expenses from continuing operations performed for DHL comprised approximately 32% and 31% of the Company's consolidated revenues from continuing operations for the three and nine month periods ending September 30, 2017. The Company’s balance sheets include accounts receivable with DHL of $12.3 million and $15.7 million as of September 30, 2018 and December 31, 2017, respectively.

The Company leases Boeing 767 aircraft to DHL under both long-term and short-term lease agreements. Under a separate crew, maintenance and insurance (“CMI”) agreement, the Company operates Boeing 767 aircraft that DHL leases from the Company. Pricing for services provided through the CMI agreement is based on pre-defined fees, scaled for the number of aircraft operated and the number of flight crews provided to DHL for its U.S. network. The Company provides DHL with scheduled maintenance services for aircraft that DHL leases. The Company also provides Boeing 767 and Boeing 757 air cargo transportation services for DHL through additional ACMI agreements in which the Company provides the aircraft, crews, maintenance and insurance under a single contract. Revenues generated from the ACMI agreements are typically based on hours flown. The Company also provides ground equipment, such as power units, air starts and related maintenance services to DHL under separate agreements.

Amazon

The Company has been providing freighter aircraft and services for cargo handling and logistical support for Amazon.com Services, Inc. ("ASI"), successor to Amazon Fulfillment Services, Inc., a subsidiary of Amazon.com, Inc. ("Amazon") since September 2015. On March 8, 2016, the Company entered into an Air Transportation Services Agreement (the “ATSA”) with ASI, pursuant to which CAM leases 20 Boeing 767 freighter aircraft to ASI, including 12 Boeing 767-200 freighter aircraft for a term of five years and eight Boeing 767-300 freighter aircraft for a term of seven years. The ATSA also provides for the operation of those aircraft by the Company’s airline subsidiaries, and the management of ground services by the Company's subsidiary LGSTX Services Inc. ("LGSTX"). The ATSA became effective on April 1, 2016 and has a term of five years. CAM owns all 20 of the Boeing 767 aircraft that are leased and operated under the ATSA.

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Revenues from continuing operations performed for Amazon comprised approximately 31% and 29% of the Company's consolidated revenues from continuing operations for the three and nine month periods ending September 30, 2018, respectively, compared to 45% and 42% for the corresponding periods of 2017. Revenues excluding directly reimbursed expenses from continuing operations performed for Amazon comprised approximately 27% and 27% of the Company's consolidated revenues from continuing operations for the three and nine month period ending September 30, 2017. The Company’s balance sheets include accounts receivable with Amazon of $37.3 million and $44.2 million as of September 30, 2018 and December 31, 2017, respectively.

In conjunction with the execution of the ATSA, the Company and Amazon entered into an Investment Agreement and a Stockholders Agreement on March 8, 2016. The Investment Agreement calls for the Company to issue warrants in three tranches which will grant Amazon the right to acquire up to 19.9% of the Company’s outstanding common shares as described below. The first tranche of warrants, issued upon the execution of the Investment Agreement and all of which are now fully vested, granted Amazon the right to purchase approximately 12.81 million ATSG common shares, with the first 7.69 million common shares vesting upon issuance on March 8, 2016, and the remaining 5.12 million common shares vesting as the Company delivered additional aircraft leased under the ATSA. The second tranche of warrants, which were issued and vested on March 8, 2018, grants Amazon the right to purchase approximately 1.59 million ATSG common shares. The third tranche of warrants will be issued and vest on September 8, 2020, and will grant Amazon the right to purchase such additional number of ATSG common shares as is necessary to bring Amazon’s ownership to 19.9% of the Company’s pre-transaction outstanding common shares measured on a GAAP-diluted basis, adjusted for share issuances and repurchases by the Company following the date of the Investment Agreement and after giving effect to the warrants granted. The exercise price of the warrants is $9.73 per share, which represents the closing price of ATSG’s common shares on February 9, 2016. Each of the three tranches of warrants are exercisable in accordance with its terms through March 8, 2021. The Company anticipates making available the common shares required for the underlying warrants through a combination of share repurchases and the issuance of additional shares.

The Company’s accounting for the warrants has been determined in accordance with the financial reporting guidance for equity-based payments to non-employees and for financial instruments. The warrants issued to Amazon as of March 8, 2016, were recorded to stockholders equity, having a fair value of $4.89 per share. At that time, the fair value of the 7.69 million vested warrants issued to Amazon was recorded as a lease incentive asset and is being amortized against revenues over the duration of the aircraft leases. On May 12, 2016, the Company’s stockholders approved an amendment to the Certificate of Incorporation of the Company at the annual meeting of stockholders to increase the number of authorized common shares and to approve the warrants in full as required under the rules of the Nasdaq Global Select Market. The stockholders' approval enabled features of the warrants that required the vested warrants of the first tranche and the warrants of the second and third tranches to be classified as financial instruments as of May 12, 2016. Accordingly, the fair value of those warrants was measured and classified in liabilities on that date. Since May 12, 2016, 5.12 million additional warrants in the first tranche vested in conjunction with the execution of eight aircraft leases. As of September 30, 2018, the Company's liabilities reflected 14.83 million warrants having a fair value of $12.55 per share. The re-measurements of the warrants to fair value resulted in non-operating gains before the effect of income taxes of $17.3 million and $25.0 million for the three and nine month periods ended September 30, 2018, respectively, compared to non-operating losses of $35.0 million and $100.6 million for the corresponding periods of 2017.

The Company's earnings in future periods will be impacted by the number of warrants granted, the re-measurements of warrant fair value, amortizations of the lease incentive asset and the related income tax effects. For income tax calculations, the value and timing of related tax deductions will differ from the guidance described above for financial reporting.

U.S. Military
A substantial portion of the Company's revenues is also derived from the U.S. Military. The U.S. Military awards flights to U.S. certificated airlines through annual contracts and through temporary "expansion" routes. Revenues from services performed for the U.S. Military were approximately 9% and 10% of the Company's total revenues from continuing operations for the three and nine month periods ending September 30, 2018, respectively, compared to 7% and 7% for the corresponding periods of 2017. Revenues excluding directly reimbursed expenses from continuing operations performed for the U.S. Military comprised approximately 10% and 10% of the Company's consolidated revenues from continuing operations for the three and nine month periods ending September 30, 2017. The Company's balance sheets included accounts receivable with the U.S. Military of 4.0 million and 6.7 million as of September 30, 2018 and December 31, 2017, respectively.

NOTE C—GOODWILL, INTANGIBLES AND EQUITY INVESTMENTS
The Company's assets for CAM and the MRO Services segments each include goodwill. An annual impairment test was performed for each, respectively, at December, 31, 2017 using industry market multiples and discounted cash flows utilizing a market-derived rate of return (level 3 fair value inputs). Goodwill was not impaired.
The carrying amounts of goodwill are as follows (in thousands):

	CAM	MRO Services	Total
Carrying value as of December 31, 2017	$34,395	$ 2,884	$37,279
Carrying value as of September 30, 2018	$34,395	$ 2,884	$37,279

The Company's acquired intangible assets are as follows (in thousands):

	Airline Certificates	Amortizing Intangibles	Total
Carrying value as of December 31, 2017	$ 3,000	$ 4,298	$7,298
Amortization	—	(867)	(867)
Carrying value as of September 30, 2018	$ 3,000	$ 3,431	$6,431

The airline certificates have an indefinite life and therefore are not amortized. The Company amortizes finite-lived intangibles assets, including customer relationship and STC intangibles, over 4 to 7 years.
Stock warrants issued to a lessee (see Note B) as an incentive are recorded as a lease incentive asset using their fair value at the time that the lessee has met its performance obligation and amortized against revenues over the duration of related aircraft leases. The Company's lease incentive granted to the lessee was as follows (in thousands):

	Lease Incentive
Carrying value as of December 31, 2017	$80,684
Amortization	(12,678)
Carrying value as of September 30, 2018	$68,006

The lease incentive began to amortize in April 2016, with the commencement of certain aircraft leases over the duration of the related leases.
In January 2014, the Company acquired a 25 percent equity interest in West Atlantic AB of Gothenburg, Sweden ("West") and in December 2017, the Company entered into a preferred equity instrument. West, through its two airlines, Atlantic Airlines Ltd. and West Air Sweden AB, operates a fleet of aircraft on behalf of European regional mail carriers and express logistics providers. The airlines operate a combined fleet of British Aerospace ATPs, Bombardier CRJ-200-PFs, and Boeing 767 and 737 aircraft. West leases three Boeing 767 aircraft and two Boeing 737 from the Company. The Company’s carrying value of West was $6.6 million and $7.1 million at September 30, 2018 and December 31,

2017, respectively, including $5.5 million of excess purchase price over the Company's fair value of West's net assets in January of 2014. The Company's equity interest and the preferred equity instrument are reflected in “Other Assets” in the Company’s consolidated balance sheets as of September 30, 2018 and December 31, 2017.
On August 3, 2017 the Company entered into a joint-venture agreement with Precision Aircraft Solutions, LLC, to develop a passenger-to-freighter conversion program for Airbus A321-200 aircraft. The Company anticipates approval of a supplemental type certificate from the FAA in 2019. The Company expects to make contributions equal to its 49% ownership percentage of the program's total costs over the next two years. The Company accounts for its investment in the joint venture under the equity method of accounting, in which the carrying value of the investment is reduced for the Company's share of the joint ventures operating losses. The carrying value of the joint venture, reflected in “Other Assets” in the Company’s consolidated balance sheets, was $6.3 million and $5.6 million at September 30, 2018 and December 31, 2017.

NOTE D—FAIR VALUE MEASUREMENTS

The Company’s money market funds and interest rate swaps are reported on the Company’s consolidated balance sheets at fair values based on market values from identical or comparable transactions. The fair value of the Company’s money market funds, stock warrant obligations, convertible note, convertible note hedges and interest rate swaps are based on observable inputs (Level 2) from comparable market transactions. The fair value of the stock warrant obligations were determined using a Black-Scholes pricing model which considers the Company’s common stock price and various assumptions, such as the volatility of the Company’s common stock, the expected dividend yield, and the risk-free interest rate. The fair value of the note conversion obligations and the convertible note hedges were estimated using a Black-Scholes pricing model and incorporate the terms and conditions of the underlying financial instruments. The valuations are, among other things, subject to changes in both the Company's credit worthiness and the counter-parties to the instruments as well as change in general market conditions. While the change in fair value of the note conversion obligations and the convertible note hedges are generally expected to move in opposite directions, the net change in any given period may be material.
The following table reflects assets and liabilities that are measured at fair value on a recurring basis (in thousands):

As of September 30, 2018	Fair Value Measurement Using			Total
	Level 1	Level 2	Level 3	
Assets				
Cash equivalents—money market	$—	$31,899	$—	$31,899
Interest rate swap	—	5,555	—	5,555
Total Assets	$—	$37,454	$—	$37,454
Liabilities				
Stock warrant obligations	—	(186,093)	—	(186,093)
Total Liabilities	$—	$(186,093)	$—	$(186,093)

As of December 31, 2017	Fair Value Measurement Using			Total
	Level 1	Level 2	Level 3	
Assets				
Cash equivalents—money market	$ —	$ 1,326	$ —	$ 1,326
Interest rate swap	—	1,840	—	1,840
Convertible note hedges	—	53,683	—	53,683
Total Assets	$ —	$ 56,849	$ —	$ 56,849
Liabilities				
Note conversion obligations	—	(54,359)	—	(54,359)
Stock warrant obligation	—	(211,136)	—	(211,136)
Total Liabilities	$ —	$ (265,495)	$ —	$ (265,495)

As a result of higher market interest rates compared to the stated interest rates of the Company’s fixed rate debt obligations, the fair value of the Company’s debt obligations, based on Level 2 observable inputs, was approximately $7.5 million less than the carrying value, which was $542.1 million at September 30, 2018. As of December 31, 2017, the fair value of the Company’s debt obligations was approximately $9.1 million more than the carrying value, which was $515.8 million. The non-financial assets, including goodwill, intangible assets and property and equipment are measured at fair value on a non-recurring basis.

NOTE E—PROPERTY AND EQUIPMENT

The Company's property and equipment consists primarily of cargo aircraft, aircraft engines and other flight equipment. Property and equipment, to be held and used, is summarized as follows (in thousands):

	September 30, 2018	December 31, 2017
Flight equipment	$ 1,927,864	$ 1,801,808
Ground equipment	55,548	53,523
Leasehold improvements, facilities and office equipment	28,609	26,897
Aircraft modifications and projects in progress	152,202	121,760
	2,164,223	2,003,988
Accumulated depreciation	(937,723)	(844,026)
Property and equipment, net	$ 1,226,500	$ 1,159,962

CAM owned aircraft with a carrying value of $733.6 million and $697.4 million that were under leases to external customers as of September 30, 2018 and December 31, 2017, respectively.

The Company’s accounting policy for major airframe and engine maintenance varies by subsidiary and aircraft type. The costs of airframe maintenance for Boeing 767-200 operated by ABX are expensed as they are incurred. The costs of major airframe maintenance for the Company's other aircraft are capitalized and amortized over the useful life of the overhaul. Many of the Company's General Electric CF6 engines that power the Boeing 767-200 aircraft are maintained under “power by the hour” and "power by the cycle" agreements with an engine maintenance provider. Further, in May 2017, the Company entered into similar maintenance agreements for certain General Electric CF6 engines that power many of the Company's Boeing 767-300 aircraft. Under these agreements, the engines are maintained by the service provider for a fixed fee per cycle and/or flight hour. As a result, the cost of maintenance for these engines is generally expensed as flights occur. During their term, these maintenance agreements contain provisions for a minimum level of flight activity. Maintenance for the airlines’ other aircraft engines, including those powering Boeing 757 aircraft, are typically contracted to service providers on a time and material basis and the costs of those engine overhauls are capitalized and amortized over the useful life of the overhaul.

NOTE F—DEBT OBLIGATIONS

Debt obligations consisted of the following (in thousands):

	September 30, 2018	December 31, 2017
Unsubordinated term loan	$59,346	$ 70,568
Revolving credit facility	280,000	245,000
Aircraft loans	—	3,640
Convertible debt	202,740	196,550
Total debt obligations	542,086	515,758
Less: current portion	(14,860)	(18,512)
Total long term obligations, net	$527,226	$ 497,246

The Company executed a syndicated credit agreement ("Senior Credit Agreement") in May 2011 which includes an unsubordinated term loan and a revolving credit facility which has a capacity of $545.0 million. The Senior Credit Agreement expires May 30, 2023. Each year, through May 6, 2019, the Company may request a one year extension of the final maturity date, subject to the lenders' consent. The Senior Credit Agreement permits additional indebtedness of up to $300.0 million for the convertible debt. The Senior Credit Agreement limits the amount of dividends the Company can pay and the amount of common stock it can repurchase to $100.0 million during any calender year, provided the Company's total secured debt to earnings before interest, taxes, depreciation and amortization expenses ("EBITDA") ratio is under 3.00 times, after giving effect to the dividend or repurchase. As of September 30, 2018, the unused revolving credit facility totaled $254.9 million, net of draws of $280.0 million and outstanding letters of credit of $10.1 million. Additionally, the Senior Credit Agreement includes an accordion feature such that the Company can now draw up to an additional $100.0 million subject to the lenders' consent.

The Senior Credit Agreement is collateralized by certain of the Company's Boeing 767 and 757 aircraft that are not collateralized under aircraft loans. Under the terms of the Senior Credit Agreement, the Company is required to maintain collateral coverage equal to 125% of the outstanding balance of the term loan and the maximum capacity of revolving credit facility or 150% of the outstanding balance of the term loan and the total funded revolving credit facility, whichever is less. The minimum collateral coverage which must be maintained is 50% of the outstanding balance of the term loan plus the revolving credit facility commitment which was $545.0 million.

The balance of the unsubordinated term loan is net of debt issuance costs of $0.7 million and $0.7 million for the periods ending September 30, 2018 and December 31, 2017, respectively. Under the terms of the Senior Credit Agreement, interest rates are adjusted quarterly based on the Company's EBITDA, its outstanding debt level and prevailing LIBOR or prime rates. At the Company's current debt-to-EBITDA ratio, the LIBOR based financing for the unsubordinated term loan and revolving credit facility bear a variable interest rate of 3.75% and 3.75%, respectively. The aircraft loan was paid off by the Company in January 2018.

The Senior Credit Agreement contains covenants including, among other things, limitations on certain additional indebtedness, guarantees of indebtedness, as well as a total debt to EBITDA ratio and a fixed charge coverage ratio. The Senior Credit Agreement stipulates events of default, including unspecified events that may have material adverse effects on the Company. If an event of default occurs, the Company may be forced to repay, renegotiate or replace the Senior Credit Agreement.

In September 2017, the Company issued $258.8 million aggregate principal amount of 1.125% Convertible Senior Notes due 2024 ("Notes") in a private offering to qualified institutional buyers pursuant to Rule 144A under the Securities Act. The Notes bear interest at a rate of 1.125% per year payable semi-annually in arrears on April 15 and October 15 each year, beginning April 15, 2018. The Notes mature on October 15, 2024, unless repurchased or converted in accordance with their terms prior to such date. The Notes are unsecured indebtedness, subordinated to the Company's existing and future secured indebtedness and other liabilities, including trade payables. Conversion of the Notes can only occur upon satisfaction of certain conditions and during certain periods, beginning in any calendar quarter commencing after December 31, 2017 and thereafter, until the close of business on the second scheduled trading day

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immediately preceding the maturity date. Upon the occurrence of certain fundamental changes, holders of the Notes can require the Company to repurchase their notes at the cash repurchase price equal to the principal amount of the notes, plus any accrued and unpaid interest.

The Notes may be settled in cash, the Company’s common shares or a combination of cash and the Company’s common shares, at the Company’s election. The initial conversion rate is 31.3475 common shares per $1,000 principal amount of Notes (equivalent to an initial conversion price of approximately $31.90 per common share). If a “make-whole fundamental change” (as defined in the offering circular with the Notes) occurs, the Company will, in certain circumstances, increase the conversion rate for a specified period of time.

In conjunction with the Notes, the Company purchased convertible note hedges having the same number of the Company’s common shares, 8.1 million shares, and same strike price of $31.90, that underlie the Notes. The convertible note hedges are expected to reduce the potential equity dilution with respect to the Company's common stock, and/or offset any cash payments in excess of the principal amount due, as the case may be, upon conversion of the Notes. The Company's current intent and policy is to settle all Note conversions through a combination settlement which satisfies the principal amount of the Notes outstanding with cash. The Notes could have a dilutive effect on the computation of earnings per share in accordance with accounting principles to the extent that the average traded market price of the Company’s common shares for a reporting period exceeds the conversion price.

The conversion feature of the Notes required bifurcation from the principal amount under the applicable accounting guidance. Settlement provisions of the Notes and the convertible note hedges required cash settlement of these instruments until the Company's shareholders increased the number of authorized shares of common stock to cover the full number of shares underlying the Notes. As a result, the conversion feature of the Notes and the convertible note hedges were initially accounted for as liabilities and assets, respectively, and marked to market at the end of each period. On May 10, 2018, the Company's shareholders increased the number of authorized shares of common stock to cover the full number of shares underlying the Notes. The Company reevaluated the Notes and convertible note hedges under the applicable accounting guidance including ASC 815, "Derivatives and Hedging," and determined that the instruments, which meet the definition of derivative and are indexed to the Company's own stock, should be classified in shareholder's equity. The fair value of the the conversion feature of the Notes and the convertible note hedges of $51.3 million and $50.6 million, respectively on May 10, 2018 were reclassified to paid-in capital.

The Notes issuance costs and discount are being amortized to interest expense through October 2024, using an effective interest rate of approximately 5.15%. The carrying value of the Company's Convertible debt is shown below:

	September 30, 2018	December 31, 2017
Principal value, Convertible Senior Notes, due 2024	258,750	258,750
Unamortized issuance costs	(6,028)	(6,685)
Unamortized discount	(49,982)	(55,515)
Convertible debt	202,740	196,550

In conjunction with the offering of the Notes, the Company also sold warrants to the convertible note hedge counterparties in separate, privately negotiated warrant transactions at a higher strike price and for the same number of the Company’s common shares, subject to customary anti-dilution adjustments. The amount received for these warrants and recorded in paid-in capital on the Company’s consolidated balance sheets was $38.5 million. These warrants could result in 8.1 million additional shares of the Company's common stock, if the Company's traded market price exceeds the strike price which is $41.35 per share and is subject to certain adjustments under the terms of the warrant transactions. The warrants could have a dilutive effect on the computation of earnings per share to the extent that the average traded market price of the Company’s common shares for a reporting period exceeds the strike price.

NOTE G—DERIVATIVE INSTRUMENTS

The Company's Senior Credit Agreement requires the Company to maintain derivative instruments for protection from fluctuating interest rates, for at least fifty percent of the outstanding balance of the term loan. Accordingly, the Company entered into interest rate swaps. The table below provides information about the Company’s interest rate swaps (in thousands):

		September 30, 2018		December 31, 2017	
Expiration Date	Stated Interest Rate	Notional Amount	Market Value (Liability)	Notional Amount	Market Value (Liability)
May 5, 2021	1.090%	30,000	929	35,625	719
May 30, 2021	1.703%	30,000	606	35,625	240
March 31, 2022	1.900%	50,000	1,657	50,000	416
March 31, 2022	1.950%	75,000	2,363	75,000	465

The outstanding interest rate swaps are not designated as hedges for accounting purposes. The effects of future fluctuations in LIBOR interest rates on derivatives held by the Company will result in the recording of unrealized gains and losses into the statement of operations. The Company recorded pre-tax gains on derivatives of $3.7 million and pre-tax losses of $0.2 million for the nine month periods ending September 30, 2018 and 2017, respectively. The liability for outstanding derivatives is recorded in other liabilities and in accrued expenses.

The Company recorded a net loss before the effects of income taxes of $0.1 million during the nine month periods ending September 30, 2018 for the revaluation of the convertible note hedges and the note conversion obligations to fair value before these instruments were reclassified to paid-in capital.

NOTE H—COMMITMENTS AND CONTINGENCIES

Lease Commitments

The Company leases portions of the air park in Wilmington, Ohio, under lease agreements with a regional port authority, the terms of which expire in May of 2019 and June of 2036 with options to extend the leases. The leased facilities include corporate offices, 310,000 square feet of maintenance hangars and a 100,000 square foot component repair shop at the air park. ABX also has the non-exclusive right to use the airport, which includes one active runway, taxi ways and ramp space. The Company also leases and operates a 311,500 square foot, two hangar aircraft maintenance complex in Tampa, Florida. Additionally, the Company leases certain equipment and airport facilities, office space, and maintenance facilities at other locations. As of September 30, 2018 and December 31, 2017, the Company did not lease any aircraft from lessors.

Purchase Commitments

The Company has agreements with Israel Aerospace Industries Ltd. ("IAI") for the conversion of Boeing 767 passenger aircraft into a standard configured freighter aircraft. The conversions primarily consist of the installation of a standard cargo door and loading system. At September 30, 2018, the Company was committed to acquire and modify additional Boeing 767-300 passenger aircraft into standard freighter aircraft. In addition to six aircraft that were in the modification process at September 30, 2018, the Company is committed to induct one more aircraft into the freighter modification process through 2019, including commitments to purchase one more Boeing 767-300 passenger aircraft during the fourth quarter of 2018. As of September 30, 2018, the Company's commitments to complete the conversions of aircraft it owns or has the contracts to purchase totaled $50.5 million. Additionally, the Company could incur a cancellation fee for part kits for any aircraft that is not inducted into conversion at IAI.

Guarantees and Indemnifications

Certain leases and agreements of the Company contain guarantees and indemnification obligations to the lessor, or one or more other parties that are considered reasonable and customary (e.g. use, tax and environmental indemnifications), the terms of which range in duration and are often limited. Such indemnification obligations may continue after expiration of the respective lease or agreement.

Other

In addition to the foregoing matters, the Company is also a party to legal proceedings in various federal and state jurisdictions from time to time arising out of the operation of the Company's business. The amount of alleged liability, if any, from these proceedings cannot be determined with certainty; however, the Company believes that its ultimate liability, if any, arising from pending legal proceedings, as well as from asserted legal claims and known potential legal claims which are probable of assertion, taking into account established accruals for estimated liabilities, should not be material to our financial condition or results of operations.

Employees Under Collective Bargaining Agreements

As of September 30, 2018, the flight crewmember employees of ABX and ATI and flight attendant employees of ATI were represented by the labor unions listed below:

Airline	Labor Agreement Unit	Percentage of the Company’s Employees
ABX	International Brotherhood of Teamsters	7.6%
ATI	Air Line Pilots Association	7.5%
ATI	Association of Flight Attendants	1.1%

NOTE I—PENSION AND OTHER POST-RETIREMENT BENEFIT PLANS

Defined Benefit and Post-retirement Healthcare Plans

ABX sponsors a qualified defined benefit pension plan for ABX crewmembers and a qualified defined benefit pension plan for a major portion of its other ABX employees that meet minimum eligibility requirements. ABX also sponsors non-qualified defined benefit pension plans for certain employees. These non-qualified plans are unfunded. Employees are no longer accruing benefits under any of the defined benefit pension plans. ABX also sponsors a post-retirement healthcare plan for its ABX employees, which is unfunded. Benefits for covered individuals terminate upon reaching age 65 under the post-retirement healthcare plans.

The accounting and valuation for these post-retirement obligations are determined by prescribed accounting and actuarial methods that consider a number of assumptions and estimates. The selection of appropriate assumptions and estimates is significant due to the long time period over which benefits will be accrued and paid. The long term nature of these benefit payouts increases the sensitivity of certain estimates of our post-retirement costs. The assumptions considered most sensitive in actuarially valuing ABX’s pension obligations and determining related expense amounts are discount rates and expected long term investment returns on plan assets. Additionally, other assumptions concerning retirement ages, mortality and employee turnover also affect the valuations. Actual results and future changes in these assumptions could result in future costs significantly higher than those recorded in our results of operations.

ABX measures plan assets and benefit obligations as of December 31 of each year. Information regarding ABX’s sponsored defined benefit pension plans and post-retirement healthcare plans follow below. The accumulated benefit obligation reflects pension benefit obligations based on the actual earnings and service to-date of current employees.

The Company’s net periodic benefit costs for its defined benefit pension plans and post-retirement healthcare plans for both continuing and discontinued operations are as follows (in thousands):

	Three Months Ended September 30,				Nine Months Ended September 30,			
	Pension Plans		Post-Retirement Healthcare Plan		Pension Plans		Post-Retirement Healthcare Plan	
	2018	2017	2018	2017	2018	2017	2018	2017
Service cost								