Conference call: CAE Healthcare acquisition of METI (Q&A only)
Time: 10:30 a.m. E.T.
Date: August 24, 2011

Operator: Our first question comes from the line of Cameron Doerksen, with National Bank Financial. Please go ahead.

Cameron Doerksen: Yes, good morning.

Marc Parent: Good morning.

Cameron Doerksen: Just a clarification first off, the $7 to $9 million in integration and transaction costs, did you say those were going to be expensed in Q2?

Stéphane Lefebvre: Yes. Well, yes, that's correct. This is what we would have seen in the past on a similar acquisition under Canadian GAAP, we would have capitalized those costs. But under IFRS those all… those costs have to be expensed as they're incurred. So it includes all of our acquisition transaction costs, advisors. It also includes costs for the integration of the company. So there's about $7 to $9 million, as I said, that we can expect in the second quarter being all expensed as a one-time cost in Q2 as part of the segment operating income of the new core market segment.

Cameron Doersken: Okay. Second question, just on the revenue growth rate for this company. Where has it been historically and what does it look like sort of on a trailing 12-month basis?

Marc Parent: It's been growing at double digits I can tell you. The last 12 months, it's in that range.

Cameron Doerksen: Okay. And I guess just finally for me, can you talk a bit about the geographic split of revenue, where is the… I would assume the majority of the revenue's generated out of U.S. But any other colour would be helpful.

Marc Parent: I think they do about 78 per cent with clients in U.S. and 22 international.

Cameron Doerksen: Okay, perfect. That's all I had. Thanks very much.

Marc Parent: Okay. Thank you.

Operator: Once again to queue up for a question, please press 1-4. Our next question comes from the line of Hamzah Mazari with Credit Suisse. Please proceed with your question.

Hamzah Mazari: Good morning. Just a couple of questions. The first question, if you could just elaborate or give some more colour as to what you're assuming for synergies on the revenue side, what you're assuming on the cost side, and how complicated do you think this integration is going to be? Or do you think it's pretty simple, given that you're closing down one manufacturing facility, moving stuff to another, and you're taking on the existing management team?

Marc Parent: Okay. I guess the first thing I'd say is I've never run across an integration I would qualify as simple. These things don't exist. But in terms of do we know what we have to do and do we think we can execute on it? Absolutely. I don't want to get into the absolute numbers, Hamzah, for a variety of reasons. Number one, competitiveness, in terms of the actual… the amount of the synergies.

But what I would tell you is there is revenue synergies that will support the deal, although that we haven't factored them in in terms of making… into the purchase decision. But really what we see there is that when you think about it, the global sales force of METI will now be able to sell much more than just patient simulators. They'll be able to sell the surgical simulators that we have, the ultrasound simulators. So there's definitely revenue synergies, more products across a similar sales force.

In terms of costs, you highlighted one there, we are going to consolidate the manufacturing operations we have currently in San José into METI's facility. They have a great facility, state-of-the-art in Sarasota. So there'll be some synergies there. And there is some synergy of management, as you would expect, and overlapping, you know, overlapping services at the fringes. So I think that's really what you're talking about. But I think their cost synergies are coming from that, and yes, we can execute on those.

Hamzah Mazari: Okay. And then just another question on capex. How much capex do you have to put into this business going forward? And given that it was private equity-owned, did they under-invest in the business? Or how should investors think about that?

Marc Parent: No, I think we've been… We've been talking to this company for quite a long time. And yes, they did a good job. Previous owners and the current CEO did a very good job. And I don't think they were putting it up for sale, if you understand what I'm saying. I think the point is they did a good job in managing the business, and that's why we selected Michael Bernstein to run the business going forward.

Hamzah Mazari: Okay. And then just lastly if you could just frame what your market share looks like out of the 750 million total addressable market post this acquisition? I know they're 40 per cent of the patient simulator market, but what does your market share look like post this deal? Thanks.

Marc Parent: I think it's early to say that, Hamzah. I don't think…

Andrew Arnovitz: Hamzah, a way to think about that is – it's Andrew here – a way to think about that is if you figure they're doing 60, 65 million in revenue currently within the human patient simulator market estimated at around 150, plus what we're doing already, which we've not admittedly disclosed relative to the mining segment. But it gives you a sense of the order of magnitude I think relative to that $750.

Marc Parent: Plus (inaudible) health care already.

Hamzah Mazari: That's very helpful. I appreciate it. Thank you.

Marc Parent: Welcome.

Operator: Our next question comes from the line of Marko Pencak, with GMP Securities. Please proceed with your question.

Marko Pencak: Thanks. Good morning. You commented that you anticipate you have a 40-per-cent market share in the human patient segment. I'm curious, the remaining 60 per cent, what's the composition of that? Are there large competitors or is it fairly fragmented?

Marc Parent: There's a couple. There's one other large competitor. It's a company called Laerdal. They're in Europe. They're a much… they're a larger company. One of their divisions does human patient simulators. Hard to say, but I think they're, based on what we've seen, it's a similar type of revenue than us. There's another company, it's much smaller, called Gaumard. I think much smaller. So I think that's about the lay of the land in that business.

Marko Pencak: Okay. And a big-picture question. I mean, you're making a decision to invest $130 million here. Why do that as opposed to say putting $130 million as an investment into one of your other four core businesses or four large segments that you have?

Marc Parent: Well, I think the one thing is I would say we already are, if you think about the capex that we're putting in the training business, largely but not exclusively, but 160 million we've talked about investing this year is mainly going in the core civil military. And beyond that, I would tell you that certainly it doesn't preclude us making investments in the other segments.

I mean, we have a strategy here that's investing in all of our businesses, and new core markets is a strategy that we have underway. It's been option value so far, but I think now we're going a little bit and giving it critical mass(?). So it's in line with our strategy, and this is really an opportunity to really give a shot in the arm to the strategy by putting our hands on a market leader in a company that has a very strong fit with CAE.

CAE, we're all about technology and the competitive advantage the technology gives you, and that's right where METI's at. So that's why we went after them, and they were not for sale. We got into a managed process with them. And largely, it was because of the fit that we thought existed between the two companies, and the market we both see going forward.

But going back to your question, certainly that doesn't preclude us investing or acquiring companies in the civil military. We continue to look at that, and we're disciplined in how we do that.

Marko Pencak: Okay. Thank you.

Operator: Our next question comes from the line of Tim James, with TD Securities. Please go ahead.

Tim James: Thank you. Good morning. Is it possible to outline, or at least discuss the economics of using simulation-based training in METI's business versus existing or legacy training methods? I know you provide some good kind of benchmarks in the aviation business. Can you talk about sort of comparable metrics or economics in this part of the health care market?

Marc Parent: I think I don't have enough detail to really answer that with the detail you'd want today, Tim. I think what I would tell you is that based on the visits that I've had in medical schools, we have a partnership with the Université de Montreal here in Montreal, and they make very strong use of these human patient simulators. And when you look at the sales, they've sold about 6,000 of these worldwide and growing. So there's clearly a business case for using them.

There's no doubt, when you see one of these in action, it really does… I look at it and I cannot stop to see the parallel with our core business and training pilots and training maintenance technicians. It's very apparent. But to give you hard numbers is hard.

I think what we'll have to do, because of the size of this business is to arrange an investor day at some point in the future, and I'll ask Andrew to do that, so we can get into that level of detail. And at that time, I'll bring Michael Bernstein who'll be able to give some solid answers on that one.

Tim James: Okay. And again, maybe this is a little difficult to answer as well then. Is it possible to sort of just speak generally about what a typical sales pitch for a METI salesperson would… how that would go with a medical institution, a military or whatever? I'm just trying to think about how these products are sold and what the argument is for moving to some of these simulators from whatever sort of training processes have been used in the past.

Marc Parent: Well, I think that what you're trying to do is that you're trying to improve education. I mean, at the end of the day, that's what these devices are used for. In a lot of cases they're in complement to what's been in the past to using animals, as an example, which clearly that has its own limitations and objections these days. There is of course anatomical differences.

And I think more importantly the salesmen – and I'm far from being a salesman of medical mannequins, but I have sat in on a couple of pitches we've made to the military, for example, because if you remember, we launched our own medical mannequin called Caesar a few months ago. And I've seen what the pitch there is.

For example, in the military, is you are training medical personnel soldiers to be able to stabilize patients in a battlefield environment. So these mannequins represent totally the human physiology, the weight of the human, the actual body mass characteristics. So a soldier can drag it out of harm's way, put it on his or her back, and stabilize it to save the patient, to stop the bleeding, get the heart beating again, get the breathing going again. And the physiology models that METI has, the kind of physiology that we are putting in our simulator was such that it basically gives you a very lifelike experience, and therefore enhancing the educational model.

Tim James: Okay. Thank you. I'm just wondering if you can talk a bit about the sort of historical profitability of METI. Has it been volatile over time, or has it generally kind of ramped up and improved as the business has grown? I'm just trying to think about sort of external influences on the business, which may have or which may influence the margins in the business or profitability.

Marc Parent: I think they've been, it's safe to say they've been profitable for the last few years that we've looked at them. There was a slight dip in 2008, like there was for most of the rest of the world. So I don't think… they're not immune just like any business to what's happening in the overall economy. But they kept growing and they kept being profitable, albeit their margins were hit a little bit during that time.

And I think at that time there was some restructuring done, not only because of the hit to sales, which only dipped a little bit, but mainly to make the business operate more efficiently.

Tim James: Okay. And I just wanted to circle back on something, a comment from earlier. There was an indication that the METI sims have 13, was it operating systems or physiology systems in it? What was that comment, Marc? I just missed that, I'm sorry.

Marc Parent: Basically, what I was saying is that one of the things we really like about METI is the level of technical sophistication of the physiology and the physiologies are all about how sophisticated are the models to represent the human body in all its systems. And I use the term system as analogy, but for example, the breathing, the circulatory system, the nervous system, so that the physiology models that they create are a very big technical differentiator for the product.

Tim James: Okay, great. And just one quick question on the numbers there. When you talk about the 8.5 times multiple on EBITDA, the transaction value, do I assume that does not include the $7 to $9 million in integration costs? That would be incremental?

Stéphane Lefebvre: The way we've done that, you look at the EBITDA of METI. I looked at the run rate of the last few months and include our synergies, but only really the past synergies that we see. And that's how we come up with the 8.5 times.

Tim James: Great. Thank you very much.

Andrew Arnovitz: Operator, before we take the next question, I would just say in the interest of fairness, if people could limit themselves to one-part questions so that we can give everybody a chance who wants to ask a question. Thank you. Please resume with the question-and-answer period.

Operator: The next question comes from the line of Michael Williamse, with CIBC. Please go ahead.

Michael Williamse: Thank you. Good morning.

Marc Parent: Good morning.

Michael Williamse: Just wondering on kind of the current macro environment, I know in your military division, even though there's a very convincing case on using more simulation in military, there seems to be bottlenecks in the system right now. Are you concerned that, especially in the U.S., some of the macro concerns and some of the questions on their health care spending that could limit growth going forward? Or I guess how do you think about that issue?

Marc Parent: Well, there's no doubt. I think that, like I said before, this segment is no different than any other segment. It could be affected, but having said that, I think there's lots of headroom for adoption of this, basically that kind of technology, the products that METI and CAE Healthcare provides. So I'm not overly concerned with that when I look at the market going forward. And I think there's lots of market expansion possible.

Michael Williamse: Okay. Thank you. I'll get back in queue.

Marc Parent: Thank you.

Operator: The next question comes from the line of Konark Gupta with Cormark Securities. Please go ahead.

Konark Gupta: Good morning, gentlemen.

Marc Parent: Good morning.

Konark Gupta: I just have a quick question on the revenue split. Basically I just want to know what sort of exposure do they have on the military, especially the U.S. Army? And what percentage of the revenues come from human patient simulators?

Marc Parent: They are exposed to the U.S. military. And I don't remember the exact split. I don't know if we have it. Maybe we can get back to you.

Andrew Arnovitz: We'll have to come back to you with that.

Marc Parent: But they do sell to the U.S. military.

Konark Gupta: Huh-huh. And what percentage of the revenues come from human patient simulators, like in that business?

Marc Parent: Essentially, I would assume 95 per cent. It's the majority.

Konark Gupta: 95?

Marc Parent: (Inaudible) majority volumes back to you.

Andrew Arnovitz: Yes, I mean, it would be above 70 per cent for the sale of the simulators. There's also a good recurring kind of revenue stream attached to that in terms of the maintenance revenues and the servicing that makes up most of the rest.

Konark Gupta: Okay. That's great. I'll get back in the queue. Thank you.

Operator: Our next question comes from the line of Benoît Poirier with Desjardins Securities. Please go ahead.

Étienne Durocher: Yes, good morning. This is Étienne Durocher speaking for Benoît this morning. I'm not sure if I missed that, but did you say how long you expected this integration to take?

Marc Parent: I think that over the next six months I think would be a good target. I mean, by the time we get around to being able to merge the manufacturing operations, I think six months is probably a good estimate.

Étienne Durocher: Okay. And when you say that when you expect your new core markets to be as large as your other four segments, do you have any idea of over which timeframe you expect that, and whether we should expect this to be more done by acquisitions or organically going forward?

Marc Parent: I think we haven't given a timeframe. I think it's fair to say that we would expect the business to grow double digits over the longer term. So we haven't really given a timeframe on that yet, Étienne.

Étienne Durocher: Okay. And should that be more acquisitions or because I think in the past you were talking more about growing organically rather than making acquisitions?

Marc Parent: I don't think there's a lot of large targets out there. I mean, this is an emerging market. I think we would not preclude doing more acquisitions if the right target is there, but there's not large targets out there that would say that we would be growing overly through acquisitions here.

Étienne Durocher: Okay. Thanks a lot for the colour.

Marc Parent: You're welcome.

Operator: The next question comes from the line of David Tyerman, from Canaccord Genuity. Please go ahead.

David Tyerman: Yes, good morning. Just on the EBITDA, including synergies at 8.5 times or that the cost was 8.5 times, should we model that kind of 15 million per year run rate right out of the chute, or is this going to take a while to occur?

Marc Parent: You're deducing the $15 million out of the EBITDA. I mean, I think I would stick to what we've said, David, is basically we expect new core markets, so we haven't broken down CAE Healthcare by itself. But really expect it to be positive next year as opposed to… We're going to continue to invest in new core markets because, as we've said previously, we have our eye on our bigger business here. So we're going to continue to invest. But having said that, it'll be profitable next year.

David Tyerman: Okay. If I can just ask one quick question then since I'm not at all clear what the answer there is other than it'll be profitable next year, could you give a bit of a rundown on what the purchase equation looks like, like how much of the $130 million is fixed assets, how much is intangibles and goodwill, how much is working cap?

Stéphane Lefebvre: Yes. This is a company that doesn't carry a lot of fixed assets. It's a company. They have a lot of technology, a good network of distributors, a good critical mass of customers. So that's really the bulk of what we're purchasing. We're right in the middle of finalizing the purchase equation at this stage. But I think we could expect probably around a third of that, between a third maybe, between a third and 40 per cent representing some, as I said, technology, distribution network, customer base and so on, and the rest will be goodwill.

David Tyerman: Okay. So the third to 40 per cent is intangibles then are you saying?

Stéphane Lefebvre: Correct.

David Tyerman: And what would that be amortized over, roughly?

Stéphane Lefebvre: Oh, I mean, it depends, depending on the proportion of the technology and customer base. We typically depreciate these kinds of intangibles over sometimes seven years, sometimes it span over… Sometimes, it's shorter – five – and in certain occasions, 10 years. So there's a bit of a span there.

As I said, I think I'll just… before I provide more details on this, I'd rather come up with the right purchase price allocation. But I think it gives you a good indication of what we've got in mind today.

David Tyerman: That's very helpful.

Marc Parent: Yes, David, just a little bit more, we're not trying to be cagey on it. The reality is we have a very good handle on it, which I know you're trying to deduce here what METI legacy business will do. Our products in healthcare that we're selling, our existing products, our surgical simulators, our ultrasound, for example, they're profitable products. We have a good and growing business in mining. But the reality is if we want to get this, which we believe, we absolutely believe the opportunity is there to make a larger business, we will want to invest and continuing to invest in R&D in both businesses to grow it larger. So right now, it's too early for me to be able to commit to any type of rate of profitability next year. But I know enough to know that as a minimum, it'll be slightly positive in our next year.

David Tyerman: Okay. And sorry, when you say slightly positive, Marc, are you saying at the EBIT line?

Marc Parent: Yes.

David Tyerman: Okay. Thank you.

Marc Parent: The EBIT line of new core markets.

David Tyerman: Right.

Marc Parent: Yes.

David Tyerman: That's great. Thank you.

Marc Parent: That's the line, right? Am I right, Andrew? Andrew's nodding.

Andrew Arnovitz: Yes.

Operator: Once again to queue up for a question, please press 1-4. The next question comes from the line of Gabriel Leung with Paradigm Capital. Please go ahead.

Gabriel Leung: Thanks. I'm just wondering if you guys can talk a little bit about average selling prices for one of these, for a typical simulator? And you had talked about some maintenance revenues associated with that. What percentage of the ASP would you expect to come from maintenance? Is it 5, 10 per cent?

Marc Parent: The first question is these simulators, depending, you see the different products I think on the presentation that we had in the slide show there. They go from about $40,000 to the top of the line model being $250 per simulator. The amount of recurring, I had the number, I'm just trying to dig it out right here, what we're talking about. Well, maybe I can't find it. I think we'll have to get back to you. Andrew will get back to you on that one.

Gabriel Leung: That's fine. And maybe just one more follow-up question. You had talked about sort of the health care simulation market being at about 750 million a year right now. I guess based on this acquisition and the previous one, you're in surgical and now human patient simulators. Can you talk about what other pieces of that $750 billion pie – million pie, sorry – you'd also want to address over the near term?

Marc Parent: Well, I can talk about what we're in, which we're growing. I think we're focused on surgical simulations, if you talk about ultrasound or imaging type simulation, human patient simulators. We do operate training centre operations. And we do train delivery of using course wear and instructors. So those are the segments we're in. Don't see anything other at the moment.

Gabriel Leung: That's great. Thank you.

Operator: Our next question is a follow-up question from Michael Williamse, from CIBC. Please go ahead.

Michael Williamse: Great. Thank you. I just had a question on the debt. So you've issued $150 million notes at 4.5 per cent. Last quarter, you had $181 million in cash, and it looked like you'd be generating quite a bit from working capital. The interest on this debt looks quite a bit cheaper than some of your other outstanding debt. Is there an opportunity to take out some of your higher cost debt?

Stéphane Lefebvre: No, it is. And if you look at, so the transaction is for 130 million. At this point in time we've issued notes for 150. So there's a 20 million that we'd want to use to refinance some older obligations that are carrying higher interest costs as we could get this time around. So we're in the process of looking into this. As far as the overall, that structure that we have, I mean I'll be looking at some other opportunities to do something like that.

The good news here is we've been able to issue for a good amount of money some notes to institutional lenders in the U.S. that were very pleased, are very pleased with CAE's financial situation. And that gave us the chance to issue those notes at fairly low rates, as well as for longer term, so matching the long-term aspects of the investment. I think we've got some very good feedback going through that process with those lenders in the past few weeks.

Michael Williamse: But with the note issued, and if you get some cash generated from working capital for the rest of the year, your cash balances, even with the acquisition, your cash balances should be pretty high for the next few quarters.

Is it the plan to… you're okay with kind of having high cash balances or I guess maybe a little bit will be used for taking out a little bit of the high-cost debt. Is that the right way to look at it?

Stéphane Lefebvre: I look at it, yes, I look at it in this way as well. I look at it a lot on the net-debt basis. If you look at where we were at the end of the last quarter, our net debt to EBITDA was fairly low at around, depending on the EBITDA, you use 1.4, 1.5 times. And adding this transaction doesn't change that ratio materially. So we're still in a very good ballpark.

As far as using existing cash to refinance some of those obligations, it's all a matter at this point in time of where our cash is in different parts of the world, and where our debt and other of our obligations are. We've got some cash in certain countries. We're going to be mindful of the cost in terms of tax to repatriate the cash and pay out some debt.

But to make a long story short, yes, cash balance is part of the equation, as well as when I look at it and I look at the cost at which we can issue debt today, I think there's a good mix here for us to look at structuring our existing debt.

Michael Williamse: Okay. Thank you.

Andrew Arnovitz: Operator, I think that's all the time we have for questions on this call. I'd like to thank all participants for their time, and to remind everyone that a transcript of the conference can be found on our website, along with a PowerPoint presentation. And of course I am available for any questions offline, should anyone want to contact me. Thank you very much.

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