

Conference call: CAE INC. Q4 and full-year FY2013

Date: MAY 16, 2013

OPERATOR: Our first question comes from the line of David Newman with Cormark Securities. Please go ahead with your question.

DAVID NEWMAN: Good afternoon, gentlemen.

MARC PARENT (President and Chief Executive Officer, CAE Inc.): Hi, David.

DAVID NEWMAN: Just on the production of civil sims in the quarter, I know, Marc sometimes you give that to us versus last year. What does that look like? And what does the pricing look like now? And maybe you can just talk a little bit about the Lockheed-backed sim industries in L-3 and how aggressive they may or may not be on pricing because we're hearing it is relatively tough out there?

MARC PARENT: Okay. Let me just break those up. The first question, I think we delivered nine simulators in the quarter and 39 for the year as a whole.

DAVID NEWMAN: Okay.

MARC PARENT: And pricing – look, pricing as I said is sharp. I mean clearly both those competitors are trying to make their mark in the business, and they're investing, and pricing reflects it. We've seen that before and we're seeing it again.

But overall I think that we'll be able to maintain our leadership in the market, and that's going to be our target.

Having said that, we're going to be prudent and a lot of our competitive strategy involves – pricing is certainly a factor, and we have to be sharp. But in the end we try to differentiate our offering. I think we're fairly successful in differentiating and using our solutions approach. That's why – and you've heard me say in the past – we've been really guiding for people to think about a combined civil margin because in a lot of cases, as we give a bundled solution sometimes you'll be orienting more towards a solution in services and various types of products sometimes even involving pilots to be able to have a competitive offer against companies that may not offer that full solution.

DAVID NEWMAN: Okay. And just if I could squeeze a quick one in there, do you see a move on right now of we-take-care-of-our-own kind of made-in-America with the loss of the KC-46 flight safety? Are you seeing a move on to kind of in-sourcing production in the U.S.? I know you have a good presence down in Tampa, but maybe just a few thoughts on that.

MARC PARENT: No, I really don't see that. The only thing I could say is we're disappointed to have lost the KC-46. I think we really put a good bid in. I think the customer's very smart. I think, as we always expected, it was a very competitive competition. Clearly there was five very

credible, strong players in there competing for the business and in the end we scored a C, we scored the top of the range in all of the categories measured by the U.S. Air Force procurement. And in the end it became a price shootout. And I think... I don't see any evidence or do I believe that there was any kind of nationalism played there.

DAVID NEWMAN: And once again, do you think pricing is because these guys are just getting – military guys are getting a little more desperate that the pricing's getting a bit more aggressive there as well?

MARC PARENT: You mean the...

DAVID NEWMAN: Yeah, just overall, as guys get a little more desperate, that the pricing gets a little tougher?

MARC PARENT: Well I think there's no doubt that when you see a program like the KC-46, there's not that many around of that size.

DAVID NEWMAN: Right, right.

MARC PARENT: So clearly whoever gets it, gets a backlog that's going to last for a long time, and our view is a good backlog is great, but a great backlog with not a great margin, you suffer with that a long time as well.

DAVID NEWMAN: Right.

MARC PARENT: So we're prudent, and we would like to win it, but we didn't base our strategy or our outlook. Anybody who's followed

what I've said over the last few years on one of my meetings or on this call has said that although I felt our chances were very good on that program, I certainly wouldn't have baked our full strategy in the outlook that we give on winning that program, purely because there was going to be at least four or now five competitors. So I think that reflects the situation.

But clearly, coming back to your question, everybody wants to win in the military, so it does become at some point like it was in KC-46, a price shootout. But I feel very good about our ability to win. If you go back, you question of nationalism, remember that we won the KC-135 aircrew training...

DAVID NEWMAN: Yeah, that's true.

MARC PARENT: ... contract. So that's a fairly big contract in itself, and we just got repeat orders in the quarter to evolving to the boom operator training. So we're adding onto that. So we're quite comfortable, although disappointed.

DAVID NEWMAN: Yeah. Okay. Thanks, Marc.

OPERATOR: Our next question comes from the line of Cameron Doerksen with National Bank Financial. Please go ahead with your question.

CAMERON DOERKSEN: Yeah, thanks. Good afternoon.

MARC PARENT: Good afternoon, Cameron.

CAMERON DOERKSEN: Question on the... I guess on the outlook, specifically in military. You've talked about the bid pipeline. And I guess to some extent my... the answer to this question's going to depend on how the timing of these awards come. But can you maybe just talk about what your expectation is for military revenue growth or declines in fiscal 2014?

MARC PARENT: Look, it's very hard to answer that question precisely because I think you answered it yourself in saying that it all depends of orders coming to fruition, and unfortunately I don't give a lot of great outlook on that. But I think what I said in my call is I believe we'll have resiliency in this market. So you say plus or minus what we did this year, more plus than minus, I would say.

To me we got a good backlog. We're starting the year pretty close to where we were last year in terms of what we've got booked. Again, I've looked, we got \$2.1 billion of orders that we've got proposals in, that are great proposals. So I fully expect that we'll be able to sustain the business. I don't think we're going to shoot the lights out, but neither do I think that we're going to go down that much.

CAMERON DOERKSEN: Okay. And then just maybe if I could also squeeze in another quick one, just a similar vein just on the full flight

simulator orders. You typically do give us a number on what you expect for the coming year. I just wonder if you can give us a rough number again?

MARC PARENT: Well, we usually give that in Q1, Cameron, and I'm going to buy myself another quarter to do that, Q1. The production rates haven't really changed; they're still high, so I mean you would expect that just going as an indication it'll be another strong year.

CAMERON DOERKSEN: Great. That's it for me. Thanks.

MARC PARENT: Thank you.

OPERATOR: Our next question comes from the line of Fadi Chamoun with BMO. Please go ahead with your question.

FADI CHAMOUN: Hi. Also a question on the outlook. On the civil aviation side, I mean there's a few things going on here. You talked about the redeployment of some sims, and the weak environment in Europe, the pricing environment is somewhat competitive, I guess, on the product side, but demand's getting better. Your utilization is low and probably rising. Oxford integration. So can you give a sense if we shake all these things sort of going into the next 12 months, do you see scope for margins to improve, and do you still see that 19 per cent target margin in civil aviation in your eyesight?

MARC PARENT: Well I think, Fadi, I think you've highlighted exactly all the moving parts this year that makes a precise answer difficult. I

mean, clearly you're right. I mean the one I think you haven't highlighted there, but as I said on my remarks, I would expect that we will realize this extra \$11 million range of cost synergies from Oxford because we're shutting the facilities down, so those costs will come forward as reductions.

We will see a higher volume. We have new simulators coming online. We have others that we've moved, that will be moved and now starting to earn revenue where they're at. We have others that we're... because of the situation in Europe, I mean that's a bit of a compounded effect. In the one hand it's more difficult, as seen in Q4, there's been a reduction in activity in Europe, but really for us, our reaction to that most likely is to move more sims out of Europe into regions where the demand is much higher. I mean, that has a short-term effect. It has a positive effect on capital deployment because we're going to put sims anyway, so it probably offsets some capital.

But look, coming back to your question, I think it'll take all those factors, it makes a precise estimate of margins pretty difficult, but what I would tell you, my expectation, we said that 19 per cent at the top of the market in commercial and civil aviation coming back. And I think those assumptions are still intact as a combined civil margin. With all the factors we have, I don't think we're going to get there this year. I don't expect business aircraft to come back to that level, just a start.

But if I look at where we finished this year, I think we should do better than that. If you asked my best estimate of that right now, I would say 17, 18 per cent on average, as a full year average, but targeted towards the back end of the year, mainly because we're going to continue to move sims.

And the other factor we talked about on the previous question is the competition. That's a wild card that in the short term could affect product margins. And if we bring a solutions approach to it, we might want to give a little bit on product margins towards a higher service margin, but the service margin of course realizes itself over a matter of time. So it's not short term.

So I think we'll do a little bit better. I think this year we're in the 16 range. I think we should do better than that as an average for the year. Again, more back-ended, but I don't think we'll get to 19 this year.

FADI CHAMOUN: Okay. The other question is of the same sort on the military side. So your book to bill is pretty on the weak side for the product and stronger on the services side. Does this suggest that maybe some... unless you get some orders product-wise you're probably going to see some pressure on the margins this year? Like, how should we think about military margin, given that mix?

MARC PARENT: Well... we have to get product orders, there's no doubt, because as you well know, the product orders turn to revenue faster than service orders. So clearly that's of strong focus of ours is to get

product orders. So look, I mean in the end it depends on what your assumptions are. At the moment... we feel we'll be able to get the product orders sustain the margins, but I think our previous margin outlook is probably... Stéphane, you want to add to it?

STÉPHANE LEFEBVRE (Vice President, Finance and Chief Financial Officer, CAE Inc.): Yeah, and you know, I look at what the kind of margins, Fadi, that we've generated in mil this year at 13 and 13.5, 13.6 per cent. You may recall in the second quarter, and I've talked about it in my remarks, there were a few one-times that sustained the margin up. But if I remove all these one-times for the year, our military margins, really the starting point is close to 12.5 per cent.

And the way I look at it is you need two things to happen to get back to the kind of levels where we've been in the past. The first thing is, obviously, restructuring, having the right cost base. And the second thing is getting some more volume.

Just in terms of trend, I think we'll expect margins to be higher on the product side and a bit lower on the service side going forward. But if I look at where we finished the year, going back to my 12.5 per cent, and we've benefited from good program mix, especially in the second half of last year, I think in order for us to get back to 15-per-cent-plus margin you probably have a couple of percentage points related to adjusting our cost

base, which we're in the process of doing, and as we said, we're completing our restructuring in the first half of this year, and probably another couple of percentage points related to getting some volume in.

But as a starting point, the way I look at my portfolio in military today, we probably have a business that's running at anywhere around 12 per cent – 11-12 per cent – and about a couple of percentage point when our business is fully restructured in Europe, another couple of percentage points with higher volume.

FADI CHAMOUN: Okay. Okay, that's great. Thank you.

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

BENOÎT POIRIER: Yeah, good afternoon. Could you maybe provide some colour about the implication of the bidding for the KC-46? I'm just wondering if the costs were incurred already, if it negatively impacted your margin or if it will impact the margin in Q1? Thanks.

MARC PARENT: No, everything was expensed, Benoît.

BENOÎT POIRIER: Okay. Perfect. Any comment about the magnitude of that cost?

MARC PARENT: We wouldn't disclose it, no. And I wouldn't get into that. I mean, it's a big bid, so it obviously cost money, no doubt about that. But that's competitive information we wouldn't want to give, Benoît.

BENOÎT POIRIER: Okay. Perfect. Thanks for the time.

MARC PARENT: You're welcome.

OPERATOR: Our next question comes from the line of David Tyerman with Canaccord Genuity. Please go ahead with your question.

DAVID TYERMAN: Good afternoon. A couple of housekeeping questions. I was wondering if you could give us some thoughts on tax rate for fiscal '14 and capex for fiscal '14?

STÉPHANE LEFEBVRE: I can certainly do that, David. So as you've seen, the tax rate – and the way I think I would look at the tax rate this year, although 13 per cent in the last quarter was very low, as I explained, that resulted from good news for us, successful closure of some tax audits that we had in different parts of the world, and it provided a net benefit of about \$0.02. So excluding that item our tax rate in the fourth quarter would have been at 22 per cent.

Now if I take the whole year and I carve out all the noise and the one-times that we had in the year, I get to a 24-per-cent tax rate that's for fiscal year '13.

Now going forward, thinking about some of the dynamics that Marc has talked about, with our German operations being restructured next year, that's a high-tax-rate jurisdiction, so I'd expect a higher taxable income coming our way from Europe, in Germany, from Europe as well,

once we get the cost synergies going in Oxford. We see some growth in the U.S., which is a high-tax-rate jurisdiction as well. So I would expect a higher tax rate next year. I think a 26-, 27-per-cent rate is a good number to use.

DAVID TYERMAN: Okay, that's great. 26, 27?

STÉPHANE LEFEBVRE: Yeah.

DAVID TYERMAN: And the capex?

STÉPHANE LEFEBVRE: Well, capex we finished at 155. I wouldn't expect that figure being very different in the next year. There's still some moving parts in the number of sims that are being relocated so we'll update you as we continue progressing going through that exercise. But I wouldn't expect a big increase in fiscal '14 from the 155 that we finished at.

DAVID TYERMAN: Okay. That's all very helpful. Thank you.

Just one other quick question on the amortization of intangibles seemed to go up in a lot of categories in Q4, unusually high; SPC, TSM and new core markets. Was that just trueing up of the year? I'm just wondering how should we think about that when we're modelling?

STÉPHANE LEFEBVRE: No. I mean, it's a good point. I think... I mean we still are going through an ERP implementation, and we've achieved some successful milestones during the year. And as soon as we hit full implementation of some modules we start depreciating the asset. So that's one part of it.

The other part of it is obviously the amortization of intangibles that we recorded as part of the Oxford acquisition. So there was nothing completely unusual in the amortization of intangibles in Q4. I think it's a good proxy to use going forward.

And if I may, while I'm on some of these items that I think are important for to think about our product level for next year, the interest line has moved as well from the beginning of the year to the fourth quarter. We finished in the fourth quarter I think the interest expense was \$18 million. And this is really I think a good proxy going forward simply because it factors in all the refinancing that we did during the year. So I would expect a interest expense around \$18-\$19 million per quarter in the interest expense per quarter in fiscal '14.

DAVID TYERMAN: Thank you very much. Very helpful.

STÉPHANE LEFEBVRE: Okay.

OPERATOR: Our next question comes from the line of Ron Epstein with Bank of America. Please go ahead with your question.

ELIZABETH: Hi. Good afternoon. It's Elizabeth in for Ron today. Just one other housekeeping question. Did you touch on what restructuring expense would be in 2014?

STÉPHANE LEFEBVRE: In 2014?

ELIZABETH: Yeah.

STÉPHANE LEFEBVRE: No. I mean, we don't expect to have any in 2014. We've closed our restructuring expense in '13. And there's still some restructuring activity. Some people will be leaving the company in the first of the year because it takes more time to complete the whole process with some of the employee unions in Europe. But we've provisioned for all that in fiscal '13.

ELIZABETH: Okay. Great. Thanks so much.

ANDREW ARNOVITZ (Vice President, Investor Relations, CAE Inc.): Operator, we require the remaining time for members of the media. I would like to thank members of the investment community for joining us on the call, and I will be available after this call to follow up with anyone who may not have had their questions answered.

So Operator, would you please open the lines to members of the media?

OPERATOR: Absolutely. Ladies and gentlemen, as a reminder, to register for a question, please press the 1-4 on your telephone.

There appears to be no questions.

ANDREW ARNOVITZ: Operator, if that's the case then perhaps we can reopen the line to members of the investment community who may not have had their questions answered. Can you please...

OPERATOR: Perfect.

OPERATOR: Yes, sir. We do have one more questions from the line of Chris Murray with PI Financial Corp. Please go ahead with your question.

CHRIS MURRAY: Thank you. Guys, I was wondering if you could talk a little bit about the success you had in the quarter with booking a pretty strong level of orders in training and services civil? And I was wondering is this sort of an indicative trend or was there something special in the quarter that actually drove that level as high as it did?

MARC PARENT: I won't go down in the detail there, but I think as indicated in the sense that there's a few of those that involve longer duration service-type deals. And that's the kind of things we want to go after. We like to do that, part of a solutions offering. So I mean when you get those you may be getting a few years at once of revenue, so there you get a good backlog from that sense.

CHRIS MURRAY: Okay. And I guess what I'm trying to think of is that a function of letting you plan either a higher utilization over the next little while and maybe be able to plan the deployment of some of the Oxford assets more efficiently?

MARC PARENT: Yeah, absolutely, because really what it does is it gives you visibility of the anticipated training load in any one of your centres or simulators, so then you can count on the revenue being there

because you've already signed them up. So the only variation then is well, the airline may have signed up say for three years of training, and when they send their pilots might vary depending when they're flying the most or not. But by and large, it gives you a very good base of business to predict your level of activity.

STÉPHANE LEFEBVRE: And Chris, this is Stéphane. If you look at the MD&A you'll see we've disclosed a number of contracts signed in the quarter, and I mean the good news for us, they're really long term by nature, so that's why you see a bigger value of order intake in the quarter.

CHRIS MURRAY: Okay. I mean is there a way to kind of describe what maybe the average life of the contracts would be in aggregate?

MARC PARENT: Well those contracts in civil – and I'll talk more generally because I can't get into specifics for some of the customers we signed up – but we've got some contracts that go for three years, could go for five, in certain cases even 10 years, so it's a bit of a mix of different terms.

CHRIS MURRAY: Okay. Great. Thank you very much.

OPERATOR: Our next question's a follow-up question from the line of David Tyerman with Canaccord Genuity. Please go ahead with your question.

DAVID TYERMAN: Yes, just a broad question on the military side and also the civil simulator side. Cam asked the question, I'm going to kind of ask it in a broad sense. We're now somewhat into sequestration now. Are things better, worse than say a year ago? Is it murkier than a year before or clearer? Can you give us any sense of that? And then on the civil equipment side, are we still in kind of a similar environment where we've been for the last couple of years or is it getting more competitive? Just wondering if you could just provide any further thoughts on those two areas?

MARC PARENT: I think sequester was a big event. I think the actual cuts, the drastic cuts that people predicted, I haven't seen them yet. Does it mean they won't come? No. I think we see activity. You see all kinds of things. You see the U.S. Air Force literally grounding 18 fighter squadrons. You see the U.S. Navy cancelling an aircraft carrier deployment. You see FAA closing down control towers. So there's no doubt there's an effect having out there.

Now for our business we haven't really seen a big change in the level of business that we're doing. It has created more uncertainty on the order side, mainly because – I said this last quarter there – some of the civil contractors that are being laid off are some of the people that actually

administer the paperwork associated with awarding contracts. So that's creating a disruption.

But we've been living in a very uncertain kind of environment for the better part of two years as regards to the U.S. military procurements. We had continuous budget resolutions. Remember we had the whole debate about fiscal cliff that leads to sequestration. I think it's a continuing environment. And we'll see. But in the end I don't think it changes the outlook that we've given.

In civil business, as I mentioned, the statistics of passenger traffic are not as high as they were last year, but they're still high. They're historically high. But again, not as high as last year. So from that point of view things are a bit lower, particularly in Europe.

If I look at competitive, yeah, it's gotten more competitive, there's no doubt in my mind it's gotten more competitive. Different competitors I would say, more competitors since last year, but if I was to compare over the history that I've been here, we've seen a number of competitors over the period of time. So as an aggregate, I wouldn't say it's not a competition level that we haven't seen before, and that we think we can be successful.

DAVID TYERMAN: All right. Okay. That's very helpful. Thank you.

ANDREW ARNOVITZ: All right, Operator, I'd like to thank all participants for joining us on the call today. And again, I'm available for

follow-ups with investors and analysts. And of course a transcript of today's remarks can be found shortly on CAE's website: CAE.com.

Thanks again and have a great afternoon.

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