Conference call: CAE INC. Q4-2014 CONFERENCE CALL
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And we'll proceed with our first question. It is from the line of Steve Arthur of RBC Capital Markets. Go right ahead.

STEVE ARTHUR: Great. Thank you very much. Just wanted to follow up on Civil margins, 17.9 per cent in the quarter. Big improvement and essentially delivered on what you were targeting over the past number of quarters. I guess looking ahead when we look at the utilization rates and the demand environment, do you foresee things sustainable at that level? Is there further room for improvement? And where do you see these things trending over the kind of three- to five-year timeframe?

MARC PARENT: Well I think there's definitely further improvement possible. I don't think that… as I said in my notes, Steve that the utilization has improved, but I think there's room to go higher than it is currently. I mean maybe a useful fact is we're at 71 per cent for Q4. If you're to look at a 10-year average for utilization in the fourth quarter you'd see 73 per cent just as an idea, just normal kind of seasonal trends you would expect 2 per cent just when we look back at Q4. So I definitely see some more potential of increased utilization, and we see the demand is there for that. At the same time we have simulators that we recently deployed and moved to new locations that have started to ramp up, but they're not finished ramping up in a lot of cases there's still room to grow. So I think look, I think we'll definitely see… if I look at the year as a whole in Civil we had 15 per cent, and I definitely think that we'll be seeing a higher average margin for the year as a whole. And I think we'll see higher peak margins. It'll be seasonal because, you know, if you look at utilization, for example, in the summer, it usually trails off because people are flying and they're not training, and that's the time we shut off the… we close down the factory. That's just one example there. But on average I think we'll see a higher margin for the year, and we should see higher peak margins as well.

STEVE ARTHUR: Okay. If the utilization kind of hits historical levels would you have any kind of a target margin level for the Civil business, say, I don't know, three or four years out?

MARC PARENT: Not one that we could really say right now, Steve. I think it'll be higher for sure. I think previously I think that we've said is that peak margins at the top of the market when things are batting on all cylinders, including the business aircraft being back, I think we've given an outlook before that we thought 19 per cent was possible when we factor in the dilution by our park aviation business there. But I think my feeling right now is we'll be going higher than that just on the basis that in this quarter here we just achieved 17.9, so I think it stands to reason we should be able to hit peak margins better than that and sustainable margins on average better when you look as a whole.

STEVE ARTHUR: That’s good colour. Thanks very much.

MARC PARENT: Thank you.

OPERATOR: And we’ll proceed with our next question. It is from the line of Cameron Doerksen from National Bank Financial. Go right ahead.

CAMERON DOERKSEN: Yeah, thanks. Good afternoon. Just before I ask my question if I could just get the utilization rate in the network for the full year?

MARC PARENT: Seventy-one per cent, right?

STÉPHANE LEFEBVRE: No. it’s not. Sixty-eight for the full year, Cameron.

MARC PARENT: Oh, yeah. It’s 68 per cent full year, Cameron.

CAMERON DOERKSEN: Okay. So, you know, my question’s just on the Military, looking at the training and services Military specifically. It had a very good revenue number in the quarter, quite a bit higher year over year. I’m just wondering if there was any specific program that kicked in that was to drive that, and, you know, what we should look from, you know, that sub segment of Military as we look ahead to 2015?

MARC PARENT: Maybe I'll just turn it over to Stéphane for more specifics, but there are specific programs that you see ramping up there. One, I'll give an example, the Predator program is one example that we signed there last year. We got the ongoing KC-135 contracts. We have some military joint ventures that are contributing to that. But I think what you're seeing there is we've been talking for a while about our focus on long-term, recurring training and services contracts. We're focused on getting that, and as we go… get… you know, pitch both in Civil and Military we're trying to get solutions involve a lot of services, but… So that's where you see the pick up.

I don't know, Stéphane, you want to add…?

STÉPHANE LEFEBVRE: No, I think you said it. They're all related to some specific contracts that Marc mentioned. We used to see… I remember the time when we used to see about $60 million a quarter in that side of the business then $65. I think what we see is just that business ramping up. What it tells me is that we're… I think we're becoming more of a service business in Military by strategy, but as well these are in line with the trends that we see on the marketplace. And as Marc said, what I like about it is it gives more visibility on future revenue, and it positions us well for future updates from that point.

MARC PARENT: Yeah, that's the key point that's important I think to know it is a part of a solution strategy is when you're Civil and Military, if you can get in and deliver services revenue, and sometimes you have to… especially on the Military what you see you tend to see lower margins in that sector. But I think we've got to look at what the big picture is, once you're down with the customer you can drive revenues coming out of products because they need to update the simulators and things like that, and we're definitely seeing those kind of trends.

CAMERON DOERKSEN: Right. Great. That's very good. Thanks very much.

MARC PARENT: Welcome.

OPERATOR: Thank you very much. Proceed to our next question. It is from the line of David Newman with Cormark. Go right ahead.

DAVID NEWMAN: Hi, guys. Just first a quick housekeeping one and then I'll ask my question. Just on the tax side, was there anything one-time in nature on the quarter with the audits or whatever? And what should we be thinking about using going forward on the effective tax rate?

STÉPHANE LEFEBVRE: Yeah. There was actually, David. And I put it in the MD&A. We've concluded… we know that we always have a number of tax audits going on in the different parts of the world. We successfully concluded two of them in the quarter in Germany and in Canada, so that gave us a… I think it's $3.4 million uptake in the... specific to the quarter.

DAVID NEWMAN: Okay. Very good.

STÉPHANE LEFEBVRE: So that's why… Yeah, so that's why…

DAVID NEWMAN: Sorry, go ahead, Stéphane.

STÉPHANE LEFEBVRE: No, that's why you saw this 14 per cent tax rate in the quarter. Now I guess you were... going forward.

DAVID NEWMAN: Yeah.

STÉPHANE LEFEBVRE: I think what I see… look, normalizing the tax rate for Q4 as well as for the year, we get to about 21 per cent. And I saw in the last number of quarters the tax rate being quite volatile, but I used to use 25 per cent internally here. I think with the way the business has performed in the past year, given that we see some growth in the U.S., and as well as the market's picked up in Europe, places where we tend to have usually higher… they're higher tax rate jurisdictions. So I don't think that 21 per cent is necessarily a good proxy, but we're probably lower than 25 per cent right now. So 22, 23 per cent is probably a good number to use. It'll vary from quarter to the other, David.

DAVID NEWMAN: Okay. That's good colour. And just on the Civil sim manufacturing side. You know, the margins were… they were pretty good. Obviously the training you had a great quarter. The Civil sim manufacturing was a little bit… looked a little bit softer to me. Is there anything going on there? You talked about partially manufactured sims, et cetera. But given the higher orders that you had and I would assume production rates to increase your absorption, anything at play here? Is the pricing from the competitors, has pricing become more difficult or anything at all that's at play in the Civil sim side?

MARC PARENT: I think that – it's Marc here. I think what you're seeing is normal mix, and in that normal mix is obviously some contracts that we have lower pricing. We talked about that previously, but there has been pressure on pricing, which I think is more sensible now. So you're seeing some of that, but I think to me I wouldn't say it's a disproportionate fact. And I think we factor that in and we have been factoring that in. It's not unexpected because obviously these sim orders are in our backlog. It's not orders that we got last week. So that's been factored into the outlook that we've given for the sim… not the sim, but the Civil margins to be in the high teens by the end of the year. And it's also factored into the outlook I gave and the first question of Steve Arthur.

DAVID NEWMAN: Okay. I just want to squeeze a quick one in here. Next year can we expect the production rates to go up, Marc or...?

MARC PARENT: You know, we really don't talk in terms of production rates. I'd rather just look at revenue, and the reason for that is that there's the higher number of, you know, new aircraft involved in the backlog, and also multi-year contracts, and sometimes multi-year contracts... first of all, you know, you look at orders on the 350. Well the 350's still in development. You know, people are ramping up their receipt of aircraft and ergo, simulators. So it's hard to talk in terms of production line, like for example, and aircraft manufacturer would, but clearly, you know, I think the level of revenue you see now is more in line. I think it'll vary seasonally, and I think you'll see it's gradually going up.

DAVID NEWMAN: Very good. Thanks, guys.

OPERATOR: Thank you very much. We'll get to our next question. It is from the line of Turan Quettawala from Scotiabank. Go right ahead with your question.

TURAN QUETTAWALA: Yes, good afternoon. I guess my question's on the Military side. I think about a year or so ago, Stéphane you had talked a little bit about improvement in Military margins. I think you had said about 200 basis points on the restructuring and then more, I guess, of revenue came back. On an analyzed basis so far your margins are pretty much flat here. So I guess my question is should we expect some improvement in margins here on the Military side in fiscal '15? And then considering that revenue's trending up a little bit does that actually accelerate the improvement?

STÉPHANE LEFEBVRE: That's true, Turan. The way I look at it is you're right, we've executed our restructuring program last year, and at one point we generated margins that were quite low, and I remember in the second quarter of last year we went as low as I think around 10 per cent or something like that. And I said we… as our restructuring program goes through you should see about 200 basis points of improvement in margin. And that's pretty much where I think we're at right now. We have a portfolio in our hands that's probably running at 12, maybe 12, 13 per cent margin as of now. What we would need to… where we could see some meaningful improvement in margin is some additional orders coming on the equipment side of the house.

Just looking for the year as a whole, we generated 13.1 per cent EBIT margin in Military. And that's an improvement from the EBIT margin that we had last year. We generated, if I recall, 12.5 per cent normalizing for some of the one-time benefits that we disclosed to you guys last year. So we saw some improvement in margin, and I think we're at 12, 13 per cent right now. There'll be some ups and downs depending on the quarter. You see that this is a business that's quite lumpy from quarter to quarter. Could be 100, 200 basis points up and down. But I think where we landed for the year is a reflection of the portfolio that we have in our hands.

TURAN QUETTAWALA: So I guess in the near term then there's not really any significant margin improvement coming on the Military side. Is that fair?

STÉPHANE LEFEBVRE: It will really depend on the equipment orders that will come in, Turan. I think Marc mentioned it earlier. We are positioned well on a number of programs, especially we're... some position in training services. So as updates and new programs come in then we could start seeing some improvement in margin.

MARC PARENT: Yeah, I would add to that. I think, you know, that's why I think you got to take what I said, resilient, and I think that speaks in terms of top and bottom line. So I guess that implies stability in terms of margin. You can expect that.

But, you know, as Stéphane was saying, it's highly dependent on order intake because… and that's why I say higher is possible. There's no doubt about that. But at this point in time… we'll stick with resilient, as we have for all of this year.

TURAN QUETTAWALA: Okay, thank you very much. And if I could just quickly sneak in one more here on the cash side. Like the cash generation's been pretty strong here. The balance sheet I guess is coming in, if I look at the numbers on the net-to-debt-to cap, is coming in below your targets now. So really looking quite good I would say. I know you've raised the dividend. Is there anything else you could talk about with regard to cash return to shareholders?

MARC PARENT: Not at this time. We've said before that I think, Turan, that we would be open to looking at various possibilities. I mean, dividends, I mean as you've seen it, we've increased it, you know, three times in the last… well, three times in the last three years. And although we don't have a policy, I mean you could see by our actions that we seem to be happy with a certain level of payout and yield. So I think, you know, probably that's reasonable to expect that we might consider that again if the conditions are right.

And we said we might be open to do other things like buybacks, but we don't have a normal course issue right now, and we'd have to bring that to our board of directors, and we're not there at the moment.

TURAN QUETTAWALA: Okay. Thank you.

OPERATOR: Thank you very much. And we'll get to our next question. It is from the line of David Tyerman from Canaccord Genuity. Go right ahead.

DAVID TYERMAN: Yes, good afternoon. Quick question on the Military side. Your backlog's been flat in sort of the $2 billion area for I think about four or five years now, which would suggest to me that the sales are likely to remain flat unless you're going to see a sudden pick up in orders. Is that a fair way of thinking of things?

MARC PARENT: Not totally because what you're not seeing there is I think… I think Stéphane, you can highlight, is JVs I think that… I mean, effect of JVs. Well… But I think the more important one is you're probably not factoring in there is the unfunded backlog. And we did highlight the number there in my notes, what the unfunded backlog number is, and it's probably about 20 per cent of our number, so...

And what we mean by unfunded backlog, just to clarify it again, is mainly contracts involving, you know, service contracts we do with the U.S. government. Like for example, Predator contract. Well that's a multi-year contract. And at any one time we'll only put in backlog the revenue we anticipate for the year that we're in for the sole reason that the U.S. government approves their budget once a year, as we saw, you know, last year when they didn't vote the budget, and, you know, they had basically shutdown the museums and other places. So we're conservative and we don't include that, but the reality is the unfunded backlog turns into revenue. Our experience on that is, you know, it must be 99 per cent.

DAVID TYERMAN: Right. Okay. So just to recap this then, it sounds like you do expect some growth when you take into account both the funded and unfunded?

MARC PARENT: Well as I said before, I think that… well, I arrange my... you know, I'll sound like a broken record here. I remain, you know, focused on being resilient. That's as far as I can see this year. I mean, the backlog involves long-term training contracts. We see the increase in revenue there this year that's pretty significant. And I think we have… there's no doubt that we have to continue to win orders every year no matter what size our backlog is. We have to feed the beast. And I'm confident that we can, and that might imply growth as well, but it's always sensitive to the orders you get a year, and I really don't have any more visibility beyond the next two to three quarters to be able to tell you whether or not we'll have growth or not, at least to a sensible version, you know, a sensible number to be able to commit to.

DAVID TYERMAN: Okay. Very good. Thank you.

MARC PARENT: But what I do know… what I do know is that the pipeline of opportunities that we're bidding is as large as it's ever been, and our win rate is good. So sometimes what you can't control is the timing. Timing tends to move, you know, more often right than left. So I think we're being safe by saying in these times, you know, in this environment I think as we said all year, and I think we turned out not bad this year, we'll be… to my mind I'm focusing on get the book to bill as high as we can and that should translate into resiliency at least this year.

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

OPERATOR: Thank you very much. Now we'll get to our next question is from the line of Anthony Scilipoti from Veritas Investments. Go right ahead.

ANTHONY SCILIPOTI: Thank you. Good morning. Or good afternoon I should say, sorry. If I understand correctly, the disclosure's going to change, just so we're clear, so then there'll be basically three segments, and so Civil will be both products and training, and Military products and training, and then New Core? Is that how we should look at the business going forward?

MARC PARENT: Yeah, that's correct, Anthony. It's becoming more and more difficult for us to look at the variances on margins separately product and services. We don't really manage the business this way anymore. You get to a point where… I mean, we offer so much bundled solutions to customers, and we tend to offer certain pricing on products and other pricing on services, and it's just we really manage the business altogether as a combined division. We don't have such a leader that runs a training services organization whatsoever. So we're really offering the full-blown solution.

The other thing, Anthony is – and you'll be very familiar with this – is the… since this… well last year, fiscal year '14, what makes it even more difficult is to explain the volatility in the margin that's driven by the change in the accounting rules for JVs. And in certain quarter – and it was so obvious in Q3 of last year, for instance, there was quite a large amount of profit recognized on the product side of the business that had to be eliminated on the service side of the business. And then when we turn around and explain the margins to our shareholders it's really becoming more difficult to do so. But more importantly we're aligning the reporting with the way we manage the business, simple as that.

The last thing I'll say, Anthony is we will continue providing some operation-driven matrix, so we'll continue reporting on the number of full fight sims that we sell. We'll continue providing all the same information on the number of sims in operation, the simulator-equivalent unit, the utilization rates, so people don't lose visibility on those key operational metrics.

ANTHONY SCILIPOTI: Okay, that's helpful, because I would say your… that's kind of the way you used to report how many year... I can't remember now, seven or so years ago was that way. And then I would say your disclosure's been fantastic, so that's good that you keep that up.

My question is if you think about the business over the last… even at least one year and you look – but I can even go back two – and you think about the multiple, and I think this is sort of asking a question that everyone seems to be wondering, and that is how do we look forward into the growth? Because you look at where the stock is trading today, both with EPS being essentially flat when you adjust for the restructuring, and EBITDA being essentially flat for the same adjustment, the stock has risen based on multiples. So the question is what are we anticipating that's coming? I see the backlog. We see the business, and maybe you can help us understand.

MARC PARENT: You want to take that, Stéphane? Okay.

STÉPHANE LEFEBVRE: Yeah. No. Well, you know, I think, Anthony, when you look at the kind of multiple that people have today, there is an expectation of earnings in the future, and that's a given. We've been, in the last year in fiscal or '13, we've been really, with all the issues that we had, especially at the beginning of – sorry, I meant fiscal ’14 – with all the issues that we had at the beginning of fiscal ’14, we really started off on a very difficult first half of the year to a point where we started the year with really soft earnings. Especially in our Civil business and it’s recovered in the second half of the year. Now if you look for the year as a whole then you look at the different businesses, as Marc said – and I’ll just recap on this. On the Civil side of the business we will… I mean, this is a market that’s very strong. We see our margins continue to improve next year in fiscal ’15 compared to fiscal ’14. In Military, this is the place where we have a little bit less visibility, but our earnings have been improving in fiscal ’14 compared to fiscal ’13. So I think that’s where the expectations are and the reason why people are using a high multiple.

MARC PARENT: Well I think the other thing I would add is that, in addition to what Stéphane was saying, is if you look at… let’s use the period that you talked about, Anthony. I mean, I think we’re in a different place in terms of the market and, you know, our fortunes within it. I mean, there was a time where we were trading, you know, for a long time around the $10 mark there, I forget what multiple that was, but… First of all, we’re (inaudible), and the thought was you looked at our revenues and our earnings in Military in a tough market, and that was reducing and the people were wondering, well where’s that going? And I think we had to prove what we did is that because of the reasons of our differentiation within the Military market that this business is not going off a cliff. And I think we demonstrated that and we continue to believe that's the case, and longer term that the Military's a growth business.

I can't provide anymore, you know, visibility than I did in the answer and question, but clearly longer term, because... just because of our position in the market, on the platforms we have, on the geographies we serve, and the fact that, you know, simulation-based training is a solution in a time of we're trying to maintain readiness in a budget cut environment. So to me that's one thing. Military's not going off a cliff. If anything it's resilient. It's a growth story in the future. So there's something to be said about that in terms of when you look at the multiple.

The bigger case obviously is the Civil business. The Civil business, I mean it's a highly-regulated industry. Arguably there's never been a better time in history in the commercial aviation sector. We are a leader in the commercial aviation sector in both selling products and the largest player by far in the delivery of training services, and we've proven in both of them that even with what was a worry of people going back, you know, just over the past year that, you know, with all the increased competition would CAE be able to maintain their leads and maintain an excessive margin within that? And I think we've demonstrated we can, and when you listen to our outlook I think it's pretty clear that we think we can continue to do that, and on top of that we think that we still have a way to go in terms of being able to increase the utilization in our training centres. And there's… as we can see just in the results that we have, there's a high degree of leverage within... you know, when you throw some more utilization at the network, the training centres that we have.

So for all those reasons, and I think the last one is, you know, the cash utilization of the business, you're seeing that we've been pretty, you know, pretty clear on our capital allocation priorities, and we've stayed true to them, and we've delivered on them in terms of continuing to invest in growth, and there's more opportunities for us for accretive growth to return, to increase the return on capital, which is another, you know, you could throw more earnings at what we've got, the business will be less capital intensive, all things being said, permit us to continue what we've said in terms of cash returns to the shareholders, and at the same time it gives us a pretty conservative balance sheet. So I think for all those reasons, I think... I would… I'm no expert. You're an expert… maybe a better expert at multiples than I am, but when I look at our business I think that we see a positive outlook that I think people are rewarding.

ANTHONY SCILIPOTI: Okay. That's very helpful. Thanks very much.

ANTHONY ARNOVITZ: Operator, we have time for one, maybe two more questions before we open the lines to the media.

OPERATOR: Certainly. We'll proceed with our next question is from the line of Ron Epstein with Bank of America. Go right ahead.

CHRISTINE LEELOG: Hi. Good afternoon. It's actually Christine Leelog(ph) calling in for Ron this afternoon. Our question is with Civil margins again. I guess when we look at the past year, what's done better than what you expected, and what really drove the outperformance in Civil margins? Was it initial conservatism regarding your cost structure or were there really better-than-expected market demand that drove all that outperformance?

MARC PARENT: I think it's a combination of all that, to be frank. I mean I think our team, we have a new team led by Nick Leontidis that came into place this year, and I think Nick and his team put… I mean, we put a pretty aggressive marker out there from the margins that we had the fourth quarter… sorry, in the first quarter. We had a bit of… we had issues at the time. We had self-inflicted issues about the number of simulators we moved and the… I'd maybe even say chaos, but certainly disruption that we created in our training centres. We had some issues with market demand in Europe and in South America. I think a lot of those issues have all resolved in a certain way incrementally, but I think the large part of it is just operational improvements, and the fact that by stabilizing the simulators that we are moving, we've come almost pretty much to the end of these moves of simulators, they start... to not only they stop costing us money just because of the cost of moving them, but they start earning revenue. So all of those factors have resulted in the numbers that we see, and they're slightly higher than we thought. We thought we'd maintain… get to the high teens, and we got 17.9, but certainly for the last half of the year it meets our outlook of high teens.

CHRISTINE LEELOG: Great. And if I can ask a second question, if that's all right? For fiscal year '14 it looks like capex for growth was about $111 million. Can you give us more colour on what's kind of the big moving pieces there, and then how we should think about capex, the cadence of capex going forward?

MARC PARENT: I think overall… well, we finished the year with $157 of capex, and it's largely… I think 70 per cent of that was growth capex, which is pretty much in line with the guidance that we had given, and that's really us having put in our networks some simulators in certain regions where the demand coming from some of our existing customers was there.

Going forward, Christine, I think you'll see a very similar level of capex in fiscal '15. The mix may be a little bit different. There's some good opportunities for us in business aviation, so I think you'll see us continue to invest overall at a very similar level in '15 than '14, but maybe a little bit heavier on the business aviation side. And certainly there's still some very good opportunities on the CAT side of our business.

CHRISTINE LEELOG: Great. Thank you.

ANDREW ARNOVITZ: Okay, Operator, that is all the time we have for questions from members of the financial community. I would ask that you now open the lines for questions to members of the media.

OPERATOR: Certainly. Once again, for members of the media, if you'd like to ask a question you can press the 1 followed by the 4 on your telephone keypad.

And Mr. Arnovitz, we seem to have no questions queued up at this time from the media.

ANDREW ARNOVITZ: Okay. Well then we'll conclude the call at this point. I wish to thank all participants for joining us today and remind you that a transcript of today's call can be found on CAE's website shortly at cae.com.

OPERATOR: Thank you very much. And ladies and gentlemen, this does conclude the conference call for today. We thank you for your participation and ask that you disconnect your lines. Have a good day, everyone.

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