

Conference call: CAE INC. Q1 CONFERENCE CALL (Q&A only)

Time: 1:00 p.m. E.T.

Date: August 11, 2010

ANDREW ARNOVITZ (Vice President, Investor Relations and Strategy, CAE Inc.): Operator, we'd now be pleased to take questions from analysts and institutional investors. Before you open the lines let me first ask that in the interest of fairness that people please limit themselves to a single one-part question. By all means, if there's more questions after that, please feel free to re-enter the queue.

OPERATOR: Thank you. And I'll take questions from the telephone lines. If you have a question please lift the handset before making a selection. At this time if you have a question you may press *1 on your telephone keypad. If at any time you wish to cancel the question you may press the # sign. Press *1 at this time if you have a question. There'll be a brief pause as participants register. We thank you for your patience.

Our first question from Cameron Doerksen for Versant Partners. Please go ahead.

CAMERON DOERKSEN: Yes, good afternoon.

MARC PARENT (President and CEO, CAE Inc.): Good afternoon.

CAMERON DOERKSEN: Question on the civil training business.

It looks like the Datamine acquisition is 100 per cent being recorded in that

segment. If that is the case, I'm just wondering what kind of impact that its inclusion would have had on the revenue and the margins?

MARC PARENT: Yes, okay. No, if you look at Datamine, yes, you're right; that's where we're reporting it in. In fact, if you take that's about \$7 million in revenue. Now what you have to look at as well, Cameron, I think is that if you're to net out that plus the revenue impact year over year from negative foreign exchange translation, which itself is about \$17 million, by itself, you're really looking at a normalized training and services civil growth of approximately 10 per cent year over year, which, to me, shows the underlying pickup in demand.

CAMERON DOERKSEN: Okay. And I'll just squeeze one other related question in on, and it's really in the same segment. There was a gain on a sale. I'm just wondering what that impact was on the margin?

MARC PARENT: Alain, do you want to take that?

ALAIN RAQUEPAS (Chief Financial Officer, CAE Inc.): Yes, it was close to \$1 million, Cameron.

CAMERON DOERKSEN: Okay.

ALAIN RAQUEPAS: You're referring to the gain in Germany on the small training? Yes.

MARC PARENT: The one thing I might have mentioned as well, Cameron, is in regards to the contribution of the new core market there. I

talked about what it means in revenue and in terms of earnings it's a bit of a drag, a slight drag.

CAMERON DOERKSEN: Okay. Perfect. Thanks very much.

OPERATOR: Thank you. Our next question is from Ron Epstein from Bank of America. Please go ahead.

ELIZABETH: Hi, it's actually Elizabeth for Ron.

MARC PARENT: Hi, Elizabeth.

ELIZABETH: Hi. For the military segment, if the revenues were down 2 per cent this quarter, what is it giving you some confidence that you can achieve the 10- to 12-per-cent growth for the year?

MARC PARENT: It's Marc. I mean, really what we're looking at is when we look at this year in particular, you look at our products and backlog, and some product's military. Most of that backlog, if you look at where we're going to execute, turn it into revenue this year. Most of it – 85, 90 per cent – we've already won. So it's for us to execute. So that's pretty much in our control, to a large extent. We still have to win some programs. So if I look at that in our capacity to execute.

Now as well what I've seen in the pipeline of orders that we feel we're well positioned to win, that's what gives us the confidence of 10 to 12. But I really feel it'll be backend loaded for some of the factors that we talked about and when Alain spoke.

ELIZABETH: Okay. Thank you.

OPERATOR: Thank you. Our next question from Benoît Poirier from Desjardins Securities. Please go ahead.

BENOÎT POIRIER: Yes. Good afternoon. When we look at your margin training services, military, it was up significantly year over year. Could you maybe quantify, Alain, what is the impact from the higher dividend from the U.K.? And also how sustainable is the extension of the maintenance contract?

ALAIN RAQUEPAS: Yes, Benoît. Like you said, the margins in TSM were a bit higher than the average, I would say a couple of points higher than what we do deliver. This is related to a contract in Europe. So we got the extension of our maintenance contract in one of our facilities in Europe. And a portion of these costs were already incurred, which explains a couple of additional points in the margin this quarter.

But overall on average, we shall continue to shoot for the sort of average margin you've seen in the past in that segment.

BENOÎT POIRIER: Okay. Thank you.

ALAIN RAQUEPAS: Welcome.

OPERATOR: Thank you. Our next question is from Tim James from TD Newcrest. Please go ahead.

TIM JAMES: Thank you. Looking at your training civil side of the business, you have an issue of pilot capacity throughout the network, I believe is 1,800 annually. Where do you see that number growing, let's say over the next two to three years? Are you fairly comfortable? Is that the capacity that you'd like to sustain here for a couple of years or do you see growing that further?

MARC PARENT: I think we said before and I think we've maintained it, that we'd be comfortable with a target of 2,500 to 3,000. And we don't have a timeline. It'll depend on the opportunities that we see there. But if you think of what we ascribe to a pilot shortage number that Boeing Airbus included in their forecast of about 18,000 pilots short a year for the next 20 years, we feel that we'd like to get a part of that, but also we want to be able to differentiate ourselves with a quality solution. That's why we'd be limiting ourselves to that.

If you look at the recent contracts we did, like the joint venture, we've expanded with China Southern to do their pilot training in Australia. That's part of that growth. And it's part of the solution sell, that with the rest of our training and products offering.

TIM JAMES: Just as part of that question, I'm just wondering if you can talk in round numbers what percentage of your training revenue

today is from ab-initio related training or that capacity of 1,800 pilots a year versus type certification and other training?

MARC PARENT: We haven't really disclosed that. We don't break it out externally, to be honest, and I don't have the number offhand either. But I don't think we're going to break it out. But if you think about... typically I think a number that would be public out there is reasonable to expect, it's probably \$100,000 U.S. per student for a pilot course. Maybe that gives you some kind of ballpark.

TIM JAMES: Okay. That's great. Thank you.

OPERATOR: Thank you. Your next question is from Marko Pencak from GMP Securities. Please go ahead.

MARKO PENCAK: Thanks. Marc, I just wanted to ask about some detail on your view on the turn of the cycle. You pointed to a number of macro factors in the industry, but if we look more specifically at your results thus far, in your civil training business you back out your other sort of new initiatives or revenues. And you look at your order intake, your book to bill is still fairly weak. And so I'm just trying to reconcile whether your comments about the turn of the cycle are more sort of macro or in your discussions with existing and perspective customers are you also finding that the pipeline of opportunities is getting bigger and you just haven't – for timing

reasons or whatever – been able to convert them into orders in your formal backlog. Can you just give me some perspective on that?

MARC PARENT: Yes, yes, sure. I think if we look at training, I think we've always said that what we would expect is to see the pickup in training first as airlines add back capacity. They haven't added at the same rate of faster pickup and they've started adding it and we're seeing it as it translates into our numbers.

I do think – and maybe Alain can expand a little bit more – when we look at the book to bill in the training and services civil business by itself, it doesn't really tell the whole story. It's different than our three other segments, which in the products segment they're manufacturing-related backlog. You have a contract; it's very, very clear, and they execute over a number of quarters.

Our training and service civil is more typical of a retail business. You'll get an order and you'll execute it directly into the quarter. And we get typically about 70 per cent of our customers that come to our training networks will renew, will come on. And I don't think that's fully reflected. That's for us to sort out, but that's not fully reflected in how we look at book to bill.

Do you want to... in that segment, you want to expand on it, Alain?

ALAIN RAQUEPAS: Yes, sure, Marc. So it's a good metric, the book to bill in TSC, but obviously much less relevant, Marco, than the book to bill in the manufacturing businesses.

Like Marc said, very difficult to have in the book to bill the revenue that we're getting in the same quarter. So if someone shows up in the network and take \$1,000 of training, you don't get it in the revenue. You get it in the revenue, but you're not getting it in the book to bill. So the indicator for us that really we monitor is the utilization rate, which we're sharing with you on a quarterly basis. And also the revenue per simulator. You have the revenue-simulator equivalent unit and you have the total revenue. When this is growing coupled with the utilization rate, this is really the metric that tells you that the business is growing more than the book to bill because it's a service unit; it's not a manufacturing unit.

MARKO PENCAK: I thank you for that detail. But if you look in terms of the prospects that you're seeing, are you finding that the level of inquiry from customers that might have more of what I would call a longer-term or recurring business – so it's not sort of the walk-in for a couple of hours, but it's more substantial – how would you characterize where they are in terms of incremental contracts with you?

MARC PARENT: I think it's anecdotal at this point, but suffice to say we are starting to see more interest coming back throughout the network. The emerging markets... it remains strong.

What I think what is coming back, we're seeing more initial comeback, initial training. During the downturn pilots were essentially frozen in their seats. And that means essentially the lion's part of our business was recurrent training, which is shorter in duration. So now we're starting to see the recurring business, the initial type certifications come back. Not in a huge way, but it's contributing more to our results.

MARKO PENCAK: Great. Thanks for that detail.

MARC PARENT: Thank you.

OPERATOR: Thank you. The next question's from David Tyerman from Canaccord Genuity. Please go ahead.

DAVID TYERMAN: Yes, good afternoon. On the military side I was wondering if you could talk about what you're actually seeing right now. Are you seeing any impact from more constrained government budgets and so on in terms of either the numbers of things they're looking at doing or the pace that they're signing contracts?

MARC PARENT: Yes, I think as we talked about, we're monitoring what's happening in the market. It's clear that in the U.S. we saw announcement by Secretary Gates a couple of days ago with pretty

sweeping changes that they're making, including drastic cuts like clothing, joint forces command. The good news to all of that, we're not exposed to any of those that were related to that.

And if I could take the U.S. on a broad sweep, including taking the budget that was passed, all the programs that had been cut we're not exposed to and those that we are, most of them – specifically helicopters, C130J type aircrafts – have seen production rate increases.

So from that point of view we haven't been affected. If I look at Europe, the U.K., Germany, clearly there's going to have to be, and they're signaling strongly that there will be defence cutbacks.

On the other hand, we haven't seen any programs that were under contract being affected nor think it will be affected. So there's a couple of opportunities that I see in the pipeline, at least one that I've seen in Germany – without saying which one it is – that's been affected that the government's decided not to do that one.

But if I look, by and large, and I net out the positives and negatives, we're exposed to the platforms that are closest to the needs of defence customers around the world: helicopters, transport aircraft, tankers, jet trainers, those types of aircraft. And at the same time, go back to the fact that simulation-based training is part of the solution. And we hear that. That's more than anecdotal.

And we really believe that ultimately this will, for reasons of budget consciousness, it will force more use of simulation-based training. As we've said before in a similar area, 100 per cent of a pilot's training has to be done on a simulator. In the military there is no such regulation. And because of it there's been a wide dispersion in the amount of training that's actually done by militaries around the world using simulators. Anecdotally it's anywhere between 30 to 50 per cent. That's the numbers I hear, but what I do hear a lot from our customers, whether they be the U.S. Navy, whether they be the U.K., is that more use of simulation-based training is in the cards.

So that's why, if I look at our outlook, I remain confident that we'll be able to continue the good order pickups that we've had, that leads to the revenue growth that we talked about.

DAVID TYERMAN: Okay. And on the margin side, on both of the sides to the business are you continuing with the guidance you had before? I think it was mid-teens for civil and 15 per cent for military. And would there be anything that would cause those to either be going up or down in the next few quarters that you can see coming down the pipe?

MARC PARENT: No, we're not changing our outlook on that. We're maintaining that for the near future until at least we disclose next time. I don't see any macro or effects that would change those any time within this year, for sure.

DAVID TYERMAN: Okay. Thank you.

OPERATOR: Thank you. Your next question is from Michael Willemse from CIBC. Please go ahead.

MICHAEL WILLEMSE: Thank you. On the military programs that are ramping up second half of the year, are these projects with long lead times? Are they going to go on for a few quarters or are they programs that might roll off after 12 months?

MARC PARENT: I think that maybe I'll answer it and I'll ask Alain to get in more detail. Typically our backlog in sim products military is about two, three years long.

MICHAEL WILLEMSE: Okay.

MARC PARENT: So that might give you an idea. Is that enough or you want Alain to expand?

ALAIN RAQUEPAS: Yes, we're referring, Michael, to the major program we won toward the end of last year. And obviously the build phase on these programs is over 24, 30 months. So that's why we're saying we're in the early development stage of these programs. But you can assume that the first come the second half of the year and next year they're going to be there also.

MICHAEL WILLEMSE: And is most of the growth happening in the simulation side or the training side?

ALAIN RAQUEPAS: Right now, I mean, we're seeing the pickup in the second half more on the product side than the training side in military.

MICHAEL WILLEMSE: Okay. Thank you.

ALAIN RAQUEPAS: You're welcome.

OPERATOR: Thank you. Our next question is from Gregory Jackson from Raymond James. Please go ahead.

GREGORY JACKSON: Good afternoon, guys.

MARC PARENT: Good afternoon.

GREGORY JACKSON: What does the acquisition environment looking like out there for you guys?

MARC PARENT: I'm not sure that it's changed very much. In our outlook, what we've said hasn't change there. We're still, in new core markets, still looking at some relatively smaller acquisitions to further our distribution channels and our expertise in the markets. And we'll continue that.

In our core markets that's where we're more open to do larger acquisitions, certainly than in the core. We're out there. We're monitoring valuations. A lot of them I think valuations of the military still are challenging in some cases, notwithstanding what's going on in potential defence cuts. But overall I don't think much has changed there.

GREGORY JACKSON: Okay. Thank you.

OPERATOR: Thank you. Our next question is from Scott Rattee from Stonecap Securities. Please go ahead.

SCOTT RATTEE: Hi, great. Thanks very much. Just a question, again, sort of circling back around to the civil training services. Normally when we sort of go into your second quarter it's seasonally weaker than the first. I guess I'm wondering whether or not you expect to sort of see that sort of seasonality again this year or will the, sort of, the recovery that we're sort of experiencing, whether or not that won't sort of mask the normal drop?

ALAIN RAQUEPAS: Seasonality is up. Hey Scott, it's Alain. Seasonality year over year is always there, but what we see, our Q2 will probably be better than Q2 last year because we're seeing signs of improvement, generally. So year over year it should improve, but the seasonality will still be there. That's what I would say. What do you think, Marc?

MARC PARENT: Yes, I agree. Plus or minus. Yes.

SCOTT RATTEE: Okay. Great. Thanks.

OPERATOR: Thank you. Our next question's Epstein from Bank of America. Please go ahead.

ELIZABETH: Hi, it's Elizabeth again. In your press release you indicated that you'd received orders for six full flight simulators. And I was

just wondering if this trend was continuing because I think that would put you above the 22 that you're guiding for the year.

MARC PARENT: I think all it takes is one day and you're held from five to six and then we're down to 20. So it depends. Typically my experience, I've run sim products for a while at CAE, summer tends to be a bit slower. People are on vacation in parts of the world. So I think we remain with the order outlook that we've said. But I would tell you that there's more activity in there that we've seen, more bids, so I think if we need to update the guidance we'll do it as we do every quarter.

ELIZABETH: Has the last month been consistent with that or...?

MARC PARENT: Yes. Yes. I think since the last quarter I think we talked about last time that we're seeing more activity out there. And that trend is continuing.

ELIZABETH: Okay.

MARC PARENT: But I don't expect, like if you like the big pickup, I wouldn't expect it because we've seen the order rate increases at Boeing Airbus, which is great. That's great. It's a very positive signal for the industry, but typically a rate increase like that will take about a year to a year and a half for that to hit the street before more airplanes come out. And typically there's a lag between the deliveries going up and us seeing the

pickup in sales of simulators. So I wouldn't expect a drastic change to what we've talked about any time soon, at least this year.

ELIZABETH: Okay. Thank you.

OPERATOR: Thank you. Our next question is from Benoît Poirier from Desjardins Securities. Please go ahead.

BENOÎT POIRIER: Yes. Thank you very much. Marc, when we look at the recent big announcement from the Canadian government, the Joint Strike Fighter, I understand if I'm right I don't think you had any exposure to that program, but what are the opportunities for CAE down the road and what are your expectations or what would you like to see?

MARC PARENT: Well, I think you're right. We're not exposed, Benoît, right now to the F35. We'll be working hard to demonstrate to the Canadian government and Lockheed Martin the value that CAE can bring, and clearly, we have a wealth of experience providing training systems for frontline combat aircraft, like the F35. We're part of the Eurofighter consortium that's currently active. We have 20 years' experience on the CF-18. We currently have over 200 people working in Mirabel supporting the F-18 that in Canada.

So it'll really depend on what the Canadian military will want. They're negotiating now and they've announced that they're going to buy

the aircraft, but the Canadian government hasn't really said what they're going to be doing in terms of logistics for the aircraft, which include training.

And really Lockheed Martin will have an offering for training for the F-35, probably in the United States. So it really will depend on what the Canadian government requirements will be with regards to training in Canada. And I believe there'll be opportunities there, but we're talking about a ways out. I think before they get the contract on the F-35 it's probably a year and a half out. And prior to being training opportunities for that, I think we're probably talking another couple of years after that. So I think we're talking about a few years out, but I would think that our chances are good.

BENOÎT POIRIER: Okay. Perfect. And maybe a second question if I can. The U.S. House and Senate leaders are working right now on an Aviation Safety Bill. I understand it's hard to quantify. I don't know if you could provide more colour, Marc, right now?

MARC PARENT: Yes. I think you're talking about one that we've seen is they're talking about increasing the number of minimum flight hours to 1,500 hours.

BENOÎT POIRIER: Exactly.

MARC PARENT: Yes. As you say, it's still in the early stages, and it's really too soon to say what it means for the training industry. But you got to believe that increased training is a positive for the industry, and for safety,

in general. And I think that really what we're trying to do here is provide better training, not just more training. So, to me, more immersive training, the kind of training that we do, we think will bring benefits, particularly the sky has become crowded and the pilots get younger because of the pilot shortage. So we'll work with those regulatory authorities to help define best practices and ensure safety, but I think it'll be a net positive. But it's too early to say what actually it means.

BENOÎT POIRIER: Okay. Thank you.

OPERATOR: Thank you. Our next question is from Tim James from TD Newcrest. Please go ahead.

TIM JAMES: Thank you. You were commenting earlier about expecting the revenue per simulator in the network to grow going forward. I'm just wondering if you can provide any commentary on how much of that is higher utilization, and if any of that expectation includes pricing improvements in the training business? I don't know if there is some ability to push on higher costs or sorry, push higher pricing through as the utilization increases or is it entirely just dependent on greater utilization?

MARC PARENT: I think the utilization's a big factor. If you look at last peak we reached 80-per-cent utilization. So I think that there's an upside there. Clearly pricing, I think pricing has improved modestly. And it

really depends of where you're talking about. Europe is still pretty crowded in terms of competitive environment. And so we'll wait and see on that one.

TIM JAMES: Thank you.

OPERATOR: Thank you. Our next question is from David Tyerman from Canaccord Genuity. Please go ahead.

DAVID TYERMAN: Yes. Just on the new businesses, you mentioned that Datamine was \$7 million incremental in the quarter. What is the total for everything incremental?

ALAIN RAQUEPAS: No, it's the total of the new core market contributor, David.

DAVID TYERMAN: Okay.

ALAIN RAQUEPAS: That's what I've said. And both are recorded against TSC or NTSC.

DAVID TYERMAN: Okay. So the total for everything is \$7 million, and it sounds like the total margin impact was a bit negative?

ALAIN RAQUEPAS: It was negative. Yes, it was a drag in this segment.

DAVID TYERMAN: Okay. That it was the total.

ALAIN RAQUEPAS: Yes.

DAVID TYERMAN: And the other question I had was on the dividend. Just wondering if you could give us any thoughts on what is driving

your dividend thought process? Do you have a target to payout range that you're trying to achieve either as a percentage of the fair price or a percentage of probably more likely of net income?

MARC PARENT: Yes, we clearly look at where we are in terms of those metrics, but that's not what drove us there, and we don't have an underlying policy at this point anyway. It's really a reflection of the confidence of our business, and the different business model that we have, which half of our revenues now are coming from a recurring sources of revenue like services. And we see we've just been through arguably the worst downturn in the history of civilization, and we've been able to generate pretty relatively good cash flows and good profits.

So it's all testimony to that that we seem confident enough and the board of directors seem confident enough to increase the dividend. And I think that still leaves us plenty of room within our balance sheet to execute the kind of growth opportunities that we see out there.

DAVID TYERMAN: Okay. Thank you.

ANDREW ARNOVITZ: Operator, we'll need to end the session for investors and financial analysts here, and I thank all for their participation. We'll reserve the last few minutes for members of the media who wish to ask questions.

OPERATOR: Certainly. Once again if you have a question and you're a member of the media, you may press *1 now on your telephone keypad. Once again you may press *1 on your telephone keypad if you're a member of the media and you have a question.

ANDREW ARNOVITZ: Operator, if there are no questions we'll conclude the call. I wish to thank everybody again for joining us and remind you this transcript of today's conference can be found on our website at cae.com. Thank you.

OPERATOR: Thank you. The conference has now ended. Please disconnect your lines at this time. We thank you for your participation.

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