CORPORATE PARTICIPANTS

Mr. Calin Rovinescu
Executive Chairman

Mr. Matthew Bromberg
President and Chief Executive Officer

Mr. Constantino Malatesta
Interim Chief Financial Officer

Mr. Andrew Arnovitz
Senior Vice President, Investor Relations and Enterprise Risk Management

Mr. Nick Leontidis
Chief Operating Officer

CONFERENCE CALL PARTICIPANTS

Fadi Chamoun
BMO Capital Markets

Krista Friesen
CIBC

Konark Gupta
Scotiabank

Benoit Poirier
Desjardins

Kristine Liwag
Morgan Stanley

Cameron Doerksen
National Bank

Matt Lee
Canaccord

Anthony Valentini
Goldman

Conor Walters
Jefferies

Jordan Lyonnais
Bank of America

James McGarragle
RBC

QUESTION AND ANSWER

Operator

We'll now begin the question and answer session. To join the question queue, you may press star then one on your telephone keypad. You will hear a tone acknowledging your request. If you are using a speakerphone, please pick up your handset before pressing any keys. To draw your question, please press star then two. One moment, please, for your first question. Your first question comes from Fadi Chamoun with BMO Capital Markets. Your line is now open.

Fadi Chamoun, BMO Capital Markets

Good morning. Thank you. Nick, I just want to say first, congratulations on your retirement, and I appreciate all the insight and help over the years. Just a couple of questions, maybe you know, around this capital efficiency focus, obviously. So you've talked a lot about kind of, you know, harvesting capital after a period of growth. Can you share a little bit how the threshold to approve capital has changed? And I'm curious, when you look at the business and you look at the opportunity to streamline the portfolio that you talked about and to sweat the asset more, what is the order magnitude return on capital this business is able to generate over the medium-longer term? Not looking for economic guidance here, but you were at one point in the past CAE generated double-digit ROIC mid-teens, ROIC in few years as well. Is this order of magnitude possible still to kind of look at over a

period of 3, 4, 5 years, potentially to see that kind of leap forward in the ROIC performance?

Matthew Bromberg, President and CEO

Fadi, thank you for the question. It's good to hear your voice. First, let me just give Nick the mic, and then I'll approach your questions.

Nick Leontidis, Chief Operating Officer

Yes. Hi, Fadi. Thanks for the kind words, and it's been a pleasure to work with -you all of these years.

Matthew Bromberg, President and CEO

Thanks again, Nick. So, Fadi, you had several questions there, and I want to make sure I answer them in the right order. Why don't you slow down and ask the first one, and I'll make sure I answer it correctly.

Fadi Chamoun, BMO Capital Markets

Yeah. First, I'm curious if you can share how the threshold to approve capitals change. You talked about kind of changing the mechanism within CAE and the threshold, how you approve capital. How has that changed? What does the threshold look like now?

Matthew Bromberg, President and CEO

So, I appreciate the question, Fadi. Yeah, we're evaluating all of our prior investments to make sure that the assumptions that went into them are still true. And that is a lens that we'll use to look at the current network and make sure it's located and optimized for today's performance. We're also reflecting today's market conditions. So when we make new investments, we want to affect the reality of where airlines are and what their growth prospects are. And through those two lenses, we're going to make a more disciplined approach going forward. Again, we have a world-leading network, one that we're very proud of, one that's a strategic advantage. And we think there's a tremendous opportunity for us to leverage that network going forward, given that we have the largest training network in the world.

Fadi Chamoun, BMO Capital Markets

And the other question was around return on invested capital. This business did double-digit ROIC not very long ago. And through all this work that you're looking at in terms of portfolio streamlining and threshold and more capital discipline, do you see a vision where we can get back to that type of double-digit ROIC in the next few years?

Matthew Bromberg, President and CEO

Yeah, Fadi, it would be premature for me to answer that question precisely today, but that is the top focus of me and the entire leadership team looking at how we've invested capital over the past five years and how we will invest capital over the next five years and so how we can make better decisions for future investment and maximize return on the current investment. So that's exactly what we're going to spend the next few months unpacking, and we'll be

able to share that with you as we talk about next year's financial outlook.

Fadi Chamoun, BMO Capital Markets

I appreciate it.

Operator

Your next question comes from Krista Friesen with CIBC. Your line is now open.

Krista Friesen

Hi, thanks for taking my question. I was just wondering if maybe you can speak to us about any surprises you've encountered so far. I appreciate you've only been in the seat for about three months now, but you've made some early changes, and just wondering if you've encountered anything unexpected.

Matthew Bromberg, President and CEO

Yeah, thank you for the question. I think there have been only positive surprises. The level of energy across the organization, the entrepreneurial focus and the strong customer relevancy is something I've seen in every part of the franchise. And so that has been an incredible reassurance. I knew that coming in, but it's a pleasant surprise. I also think the depth of our technology and how we can better leverage defence and civil is an opportunity I hope to unlock and quantify over the next few quarters. So all that's been very reassuring.

Krista Friesen, CIBC

Okay, great. And as you'd mentioned in your opening remarks and in the press release, there have been some initial organizational changes. Are there any opportunities you see in the near term, in the next quarter or two, for additional changes you can implement before maybe we get your full, full blueprint for the company?

Matthew Bromberg, President and CEO

Yeah, I appreciate the question. So, the focus now is on giving the new team time to assess the responsibilities and create the strategic path going forward, and as that team is in place, we'll be able to share the objectives and the measurements we're going to use to chart the progress forward. So give us a few quarters. I have led transformations like this many, many times over my 25 years. And it's about identifying the opportunity, putting a team in place, identifying the measurement objectives, and then letting them run. And that's what we intend to do.

Krista Friesen, CIBC

Okay, great. Thank you. I'll jump back in the queue.

Operator

Your next question comes from Konark Gupta with Scotiabank. Your line is now open.

Konark Gupta, Scotiabank

Thanks, operator. Good morning. And I echo congratulations, Nick, for a remarkable career you had at CAE. My first question is on the CapEx side. I think you guys announced a 10% reduction in CapEx versus last year. How much of that is market condition-driven as opposed to your capital allocation decisions you have taken early on? And of that CapEx, how much is that one large defence contract that you can share?

Constantino Malatesta, Interim CFO

Hey, good morning, Konark. Thank you for the question. It's good hearing from you. So, what I think is important to reiterate effectively is that we are reducing CapEx by 10% compared to last year. About one third of that is maintenance, and 2/3 of that is growth and is driven really by a 25% reduction in civil CapEx. That is a reflection of really are disciplined approach to capital. So it is a reflection of the slowdown, the lull, the temporary lull in the activity. And so we have adjusted and used the agility that we've implemented here to adjust the CapEx on a growth-forward basis. About 40% of the growth CapEx this quarter was for the FSTSS program, specifically on the defensive and security side of the business.

Konark Gupta, Scotiabank

Okay, that's helpful, Dino. Thank you. And on the leverage ratio side of things, you know, I think it's more sort of a broader strategy question long-term. But you know, you guys are on very much track on a 2.5 times leverage ratio by the end of this fiscal year. And this is when the civil market is not, you know, running full steam at this point. And you've just started the transformation plan, Matt. So, if you're disciplined on capital allocation, my guess is you might have an underlevered balance sheet over time. So how do you bring that to a reasonable level?

Matthew Bromberg, President and CEO

Yeah, thanks for the question. So our first and primary focus on the balance sheet is going to continue to delever. And secondly, as we look at investing for some transformation, because it does take investment, we'll ensure that it meets our return thresholds going forward and and that'll be the objective for the foreseeable future. Any change in a capital allocation strategy will be something we take up with the board. But that's not in the near-term horizon.

Konark Gupta, Scotiabank

Okay, I appreciate that. Thank you.

Operator

Your next question comes from Benoit Poirier with Desjardins. Your line is now open.

Benoit Poirier, Desjardins

Yeah, thank you very much. And good morning, everyone. Just looking at the capital employed for civil, Matt. It reached 6 billion at the end of Q2, which was up basically from 5.1 billion a year ago and has basically doubled over seven years. And if I look at civil revenue, it was up about only 50% over this timeframe. So could you talk about the potential opportunity to maybe optimize capital employed? And when we look at the utilization rate of 64% in the

quarter, if we put aside the pandemic, it looks like it's almost a trust level that was reached during the great financial crisis and also during September 2001. So, any optimal level that you would consider for the overall training network? Thank you, Matt.

Matthew Bromberg, President and CEO

Yeah, it's a great question, and I appreciate you asking it. As we look over the past five years, we've made significant investments in acquisitions and building out our network and some of our research and technology. And so what we're doing now is charting the path going forward. I can tell you there's some strategic advantages to the investments of the past. One, we have this fantastic defence portfolio, which is timed perfectly with a worldwide increase in defence spending, a once-in-a-generation opportunity. And on the civil side, we have the world's largest training network, one that's poised for the recovery, which is inevitable. So we're going to leverage both of those. But we will come back at the end of the year and talk about how we'll allocate capital going forward between M&A and between capital allocation in the civil network and our research and development in general. I think that the amount we spend on capital and the amount we spend on research and development is high for a company of CAE's size. And I see opportunity to reduce it, but that'll be something we talk about as we get into next year's guidance.

Benoit Poirier, Desjardins

Okay. And Matt, maybe any thoughts about the potential training opportunity for the sizable bizjet order placed by Bond Aviation, and whether any new investment would be required, or current training network can support such a training opportunity?

Matthew Bromberg, President and CEO

Yeah, I'll turn that over to Nick.

Nick Leontidis, Chief Operating Officer

Yeah. So, Bond is going to be a customer there. This is a Bombardier win with a large order. So as they start to ramp up the deliveries. You know, we're going to be training Bond as a customer.

Benoit Poirier, Desjardins

That's great. And maybe last one for me, Matt, you attended the Canadian Aerospace Summit in Ottawa toward the end of October. I suspect you met several industry participants. So, any key takeaways from your meeting, and what are the next steps for building Canada's defence industrial strategy? Thank you.

Matthew Bromberg, President and CEO

Yeah, thank you for the question. I enjoyed the conference, and I'm just getting to know all the defence industry-based participants here in Canada. And as Calin commented on the remarks, this is a once-in-a-generation opportunity for Canada to grow its defence industrial base. And my message to the participants in the conference and to the team internally is this is our moment as a Canadian company to participate in the growth of a Canadian-based industrial--defence industrial base that will not only be important for Canada, but important would be important for the world. So that was my message to the conference, that was the topic of my speech,

and that's something that I'm very committed to drive from the CAE standpoint.

Calin Rovinescu, Executive Chairman

And Benoit, it's Calin here. So I'm going to add one thought to that as well. One of the potential additional opportunities here is that when Canada purchases equipment, aircraft capabilities from other international providers where Canada doesn't have current capabilities, if there's a training footprint that attaches to that, if there's a mission readiness footprint that attaches to that, there are opportunities for CAE and frankly for other Canadian companies to participate in some of those opportunities globally as a--almost as a requirement of the Canadian government. So, the Canadian government is more open to that than they've been in the past, given, you know, the focus on promoting from an industrial policy perspective, Canadian companies. So, there's an opportunity inside Canada for Canadian defence spending, and there's an additional opportunity outside Canada where Canada purchases international capabilities. So that's a secondary interesting opportunity that will play out with the fullness of time.

Benoit Poirier, Desjardins

That's great, Calin. Thank you very much for the time.

Operator

Your next question comes from Kristine Liwag with Morgan Stanley. Your line is now open.

Kristine Liwag, Morgan Stanley

Hi, good morning everyone. Matt, I wanted to understand a little bit better where you are in the process of the new ROIC threshold. It sounds like it's going to be higher than where it is, but I want to understand better. Are you in the process of identifying and firming up where this new level should be, or have you already identified it and we'll share at a later date? Any more information on this and your process would be helpful.

Matthew Bromberg, President and CEO

Thanks for the question. The answer is yes, we've identified higher thresholds, but our capital base is large and doesn't move quickly. And we need to take time to sort out how we can drive top-line performance out of the existing investments and ensure we make the right decisions going forward for future investments. We're not going to miss opportunities to grow our business. We're committed to growing our core markets. But we need to figure out how to leverage this capital base, which is a strategic asset. So all that guidance will come out as we announce financial guidance for 2027 and beyond. So, thanks for the question.

Kristine Liwag, Morgan Stanley

Great. Thank you very much.

Operator

Your next question comes from Cameron Doerksen with National Bank. Your line is now open.

Cameron Doerksen, National Bank

Yeah, thanks very much. Good morning. Just, I guess, a question on the timeline of when we should expect to see margin improvement, free cash flow improvement. Certainly, we can appreciate that you've got a lot of initiatives here that you've talked about today that are going to take some time. But is it to be expected that we see some benefit to the bottom line as we get into fiscal 2027 from these initiatives, or is it something that you think might take longer than that to really realize some of the benefits?

Matthew Bromberg, President and CEO

Yeah, thank you for the question. As I've said earlier, we're not going to be giving 2027 guidance today. But having led transformations like this in the past, some initiatives will be shorter-term and yield immediate results, and some will take quarters or years to develop. But that's what we're going to spend the next couple of quarters refining and then articulate that at the end of the year. So I commit to providing you with more guidance and more visibility as we present 2027 guidance.

Cameron Doerksen, National Bank

Okay, fair enough. On the sort of portfolio you've talked a little bit about, I guess, some of the contracts you have long-term contracts and perhaps some of them don't fit the return profile anymore. I guess what's the ability to either reprice some of these contracts or get out of them earlier? Is this something that we would have to see those contracts kind of run off before we'd see the bottom-line benefits? Thoughts on how that might play out?

Matthew Bromberg, President and CEO

Yeah, it's a great question, and it is an approach we look at pragmatically with all options on the table. Some contracts we can go renegotiate because we see long-term strategic value. Others we have to try out. And so there's not a single answer to that. But it's one that I've challenged a team to put everything on the table, and we'll look at each one and find the right answer, and that'll create that ladder of opportunity that will start to articulate at the end of the year.

Cameron Doerksen, National Bank

Okay, appreciate the time. Thanks very much.

Operator

Your next question comes from Matthew Lee with Canaccord Genuity. Your line is now open.

Matt Lee, Canaccord

Morning, guys. Most of my questions have already been answered, but maybe just on the civil side, can you expand on what type of concrete signs you're watching for that would help indicate a turn in simulated orders, and you know, when should we expect that to show up first where rather utilization or new FFS orders? Thanks.

Matthew Bromberg, President and CEO

Yeah, it's a great question. I thank you for asking it. I've been watching this interview for 25 years and a quarter, or two of movement is not something that concerns me. The long-term fundamentals are what really matter here. The demand for air traffic will continue to grow. 80% of the world's population hasn't flown. The major airframers have eight to 10 years of backlog, and there's a year of aircraft on the ground. So as all those things start to recover, and they will, we're the world leader in both flight--full flight formulator sales and training. And so we will benefit. From a lead time perspective, when an airline hires, it could be about six months before they start training, depending on their indoctrination and onboarding process. And when someone orders a full flight simulator, it's a year to 18 months lead time. So that's one of the reasons why we adjusted the second half of the year. We're seeing softness that we won't see recover in this fiscal year, and we're looking into next year, and we'll provide that guidance here towards the end of the year. So thanks for the question.

Matt Lee, Canaccord

Yeah, that's helpful. Just a clarification here. It sounds like your growth guidance reduction in civil was mainly due to low deliveries for the year. My understanding was that usually deliveries are a bit of a lower margin business than trading. So if so, shouldn't margins be better year-over-year, and if no,t maybe there's some factors I'm not considering.

Constantino Malatesta, Interim CFO

Hi, Matthew. So, I'll take that question. The reality is that we see both lower deliveries, yes, anticipated also in the second half, but also the utilization rate. There is a ramp-up, effectively as the softness comes back, as the overhang essentially comes back, and we'll see utilization increase. And so it's actually a mix of both full flight simulator delivery, annualization in cat and a little bit in the back to business as well as things pick up, we'll, we'll see a ramp up of, of margins going forward into '27 and beyond.

Matt Lee, Canaccord

Understood, thank you very much.

Operator

Your next question comes from Anthony Valentini with Goldman Sachs. Your line is now open.

Anthony Valentini, Goldman

Hey, guys. Thank you so much for the question. Matt, I just want to put a little bit of a, you know, finer point on this. I think that the company historically had talked about pre-tax returns on capital of 20 to 30% within two years for each simulator that, you know, was deployed into the network. You know, given the focus on the operational excellence and removing costs, I'm curious if now that target is higher or if that the company just, you know, kind of got away from some discipline of achieving those returns, and you feel like you can get the company back to those levels.

Matthew Bromberg, President and CEO

Thank you for the question. What really matters to me is what we're going to do going forward. And we

have this world-class network. It's a field of strawberries that are going to continue to grow, and we want to harvest it. And we will be more diligent about where we put simulators in the future. And that's based on higher return thresholds. And we're current simulators, and they were made with the right intention, the right investment, the right business case in the past. But the world has changed, and we'll make decisions on whether we relocate them or whether we retire them. And that's the activity that's underway. And so as we come out at the end of the year, what matters is not where we've been, but what we do with this fantastic strategic asset and the decisions we make going forward.

Anthony Valentini, Goldman

Okay, totally fair. Last one for me is I would just love to get your view on, you know, the evolving defence environment. You know, obviously, the macro is really strong, but it seems like there's a push to get, you know, more autonomous systems and drones into the hands of the warfighter. How does that impact CAE's business? I mean, is there less training that is involved for those types of systems, or, you know, is there still a lot of training that needs to happen?

Matthew Bromberg, President and CEO

Yeah, I appreciate the question. And the space of drones and, you know, collaborative combat air and remote pilot of vehicles is a very important growing market opportunity, and we're actively participating. And the short answer is yes. When you train pilots, whether they're remote or operating systems of aircraft, training is required. And we have a fantastic partnership, for example, with General Atomics, and we do their Predator training platform that supports not only the US operator, but the international operators as well. So drones remotely pilot vehicles is a big part of the future for the defence services. It's something we're very well positioned in with our modelling capability and something we're continuing to grow as we look forward. Thanks for the question.

Anthony Valentini, Goldman

Great. Thank you, Matt.

Operator

Your next question comes from Conor Walters with Jefferies. Your line is now open.

Conor Walters, Jefferies

Hi, guys. Thanks for taking my questions, and congrats to Nick on a great career here. I wanted to follow up on DNS. In your prepared remarks, you guys attributed the 14% year-over-year growth to the ramp-up of new margin accretive contracts. When we look sequentially, margins remain flat, and the guide is kind of calling for them to remain in this ballpark. So with that favourable macro backdrop and demand environment, how sustainable do you think that level of growth could be, and how should we be thinking about the underlying mix dynamics through the year here?

Constantino Malatesta, Interim CFO

Hi Conor, this is Dino, and I'll take that question, and thanks for asking it. So, I think effectively what we're seeing now is those higher margin contracts ramping up and being signed and executed. And we're seeing

some of the lower margin contracts kind of get completed and done. There's also this, I think, opportunity that we're looking at for cost optimization. One of the offsets to the profitability in this quarter is higher SGNA. That kind of offsets some of that profitability even as those margins are coming on. So, as Matt I think talked about, we're looking at all angles to optimize our structure, look at better ways to be more efficient and will drive that margin higher as we go forward and as we continue to sign those higher margin contracts and they come on board.

Conor Walters, Jefferies

Perfect. Thanks so much.

Operator

Your next question comes from Jordan Lyonnais with Bank of America. Your line is now open.

Jordan Lyonnais, Bank of America

Hey, good morning. Thanks for taking the question. I just wanted to follow up on Defence. So the product revenue in the quarter was really strong year-over-year. How much of that should we expect will just continue throughout the rest of the year? And then also on the defence business, for where you want to take it, push margin growth. How are you looking at that post, Hegseth's comments about reducing cost plus contracts, companies taking on more of their own developmental risk? And what is your protection against taking on other fixed price contracts that could go awry again?

Matthew Bromberg, President and CEO

Yeah, thanks for the question. Let me answer the last one, and then I'll turn Dino over to answer the first. What's unique about CAE is we have the size and capability to respond to what all the Defence departments are looking for. We are a commercially organized entity with a defence business, which means we can go after fixed price contacts contracts and have the ability to execute or if it's necessary to a cost-type development contract. I've been doing this for 15 years, and I've never seen a more nimble, capable company than CAE. We're also very flexible in how we go to market around the world. I think all those are really what Hegseth is trying to encourage from the large defence companies, and we have the opportunity to participate in that arena. So I'm looking forward to leveraging our skills, our technology, our operational base to answer the needs of both the US, Canada and the rest of the world. Dino.

Constantino Malatesta, Interim CFO

Thanks, Matt. So, I'll talk about that first part of the question. So, effectively, there is a higher percentage or proportion of product revenue on the defence side this quarter this year to date. And effectively, on the defence side, product businesses tend to have higher margins than the training business. What's driving that is effectively new contracts and recently signed contracts ramping up this year. The big ones, as we had talked about previously, is the Canadian fact contract, the one that been subcontracted to CAE, where the first five years were delivering mainly products and then in the last 20 years it's essentially sustainment. And there's a couple of other contracts in the US that we're signed in the quarter that's allowed us to recognize good margins on as they ramp up.

Jordan Lyonnais, Bank of America

Got it. Thank you both.

Operator

Once again, if you have a question, please press star then one. Your next question comes from James McGarragle with RBC. Your line is now open.

James McGarragle, RBC

Hey, thanks for having me on. I just wanted to ask a follow-up question on the lower CapEx guide. You know, you referenced a step down due to the slower pace of demand in civil, but you know, that said, is this the appropriate level of CapEx that we should expect going forward? And you know, should we interpret this reduction in CapEx as a signal of potentially lower growth in 2027? Or you know, do you think you can drive growth just through improving utilization in that segment? Just trying to understand how that aligns with your longer-term outlook for the civil segment.

Matthew Bromberg, President and CEO

Yeah, James, I guess we saved the best question for last, and I appreciate it. As I mentioned earlier, the amount we invest in capital, growth CapEx, maintenance CapEx, I view them together, and research and development is high for a company of our size, and what we're going to do is determine what that level should be. But we will make the right investments to continue growing. We'll make them in the right place and in the right segments. And as I said earlier, we have a world-class network. We produce more full-flight simulators than anyone else in the world and and we have fantastic customer relevancy. So, as we moderate and come out with guidance in 2027, we'll provide full visibility to where we think the next few years will come. And I really appreciate the question from you and everyone else this morning.

James McGarragle, RBC

Thank you, Matt.

Matthew Bromberg, President and CEO

Thanks, all. I'll turn the line over.

Andrew Arnovitz, Senior Vice President, Investor Relations

Thank you, and thank you, Matt and team. We seem to have run the hour here. Operator will conclude the call here. I want to thank all the participants who joined us this morning and all the financial analysts for their questions. Remind you that a transcript will be available later today on CAE's website. Thank you, and have a good day.

Operator

This brings to a close today's conference call. You may disconnect your lines. Thank you for participating, and have a pleasant day.