CAE Inc. Fiscal 2023 Second Quarter Conference Call
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QUESTION AND ANSWER SESSION

Andrew Arnovitz, Senior Vice President, Investor Relations & Enterprise Risk Management

Operator, we'd now be pleased to take questions from financial analysts.

Operator

Thank you. For analysts wishing to ask a question or comment, please press the one followed by the four on your telephone. You will hear a three-tone prompt to acknowledge your request. If your question has been answered and you would like to withdraw your registration, please press the one followed by the three. One moment please for our first question.

The first question comes from Kevin Chiang of CIBC. Please go ahead.

Kevin Chiang, CIBC World Markets

Thanks for taking my question. Maybe just the first one here. I believe the US Department of Defense issued a memo to contractors for equitable adjustments for cost overruns just given the unprecedented inflation. And I believe CAE has applied for some of these adjustments to maybe help offset previous inflation. Just wondering where that sits sits today? And I know you're starting to see maybe some of those adjustments show up either in the quarter that just ended or maybe in the back half of this fiscal year?

Marc Parent, President & Chief Executive Officer

Well, I can certainly confirm that there's a lot of effort going on in that very regard, Kevin, whether it be direct representation by us to lawmakers at the US Capitol and through combined efforts that we do with industry associations.

And letters have gone out, and I fully expect action to occur there. When that may happen, I really can't tell you. But I've always been of the view -- and we've shared this on the last call – that we expect that we will have some measure of mitigation on some of these cost overruns that have occurred. We've taken no benefit from that so far. But I fully expect in the future that we'll get some.

Kevin Chiang, CIBC World Markets

Okay. That's helpful. And just my second question. On the last quarterly call, you provided a lot of detail on the problem contracts that resulted in the write-down, one of them the legacy CAE defense contract.

And I think one of the issues was, just the expected renewal of that contract was maybe not coming in as fast as originally anticipated, which maybe drove some of that write-down? Just any update there in terms of the bidding process for that and maybe your confidence in being awarded the renewal?

Marc Parent, President & Chief Executive Officer

Well, I would tell you that the RFP is out, and we are bidding on it. So the nature of the contract has changed. I think it's a lot more attractive in terms of a contract. So, look, we'll see. I think, we have a very attractive bid, we're the incumbent. So I have high hopes. But we'll be very prudent in that regard.

Kevin Chiang, CIBC World Markets

Okay.

Marc Parent, President & Chief Executive Officer

And the one thing I'll tell you -- as testament to what I was saying in terms of the changing nature of this particular contract and others -- is what that contract looks like. It's changed from really being at the lowest-price technically-assembled contract that we saw initially to now a contract that's based more on best value, that plays very well to CAE's strengths, meaning not just around cost.

And the way we bid it is for the terms that are in the contract, which includes specific banding around utilization rates. So the risk that we saw on that contract where we basically bid at a certain level of utilization and the amount of utilization the customer made, it was much higher, we wouldn't have that risk anymore. That's been completely taken out of the risk profile of the contract.

Kevin Chiang, CIBC World Markets

That's good to hear. I'll leave it there. Thank you, very much.

Marc Parent, President & Chief Executive Officer

Thank you.

Operator

Thank you. The next question comes from Fadi Chamoun of BMO. Please go ahead.

Fadi Chamoun, BMO Capital Markets

Thank you. Good afternoon. Just one quick clarification first. Did I hear you mention that in Civil you expect the growth in the second half to exceed the growth in the first half from an EBIT perspective? Is that the guidance?

Marc Parent, President & Chief Executive Officer

Yes. It is, Fadi.

Fadi Chamoun, BMO Capital Markets

Okay. Okay. So that's quite stronger than I think what you were expecting, maybe at the beginning of the year. What's driving that specifically in aviation? I mean, you've had some decent amount of order year-to-date, and it looks like sequentially in the second quarter, we've had a big jump, more than seasonal jump, I would say, in the second versus the first. Like, is Asian market coming back a little bit stronger? Is there an area that kind of surprised you on the positive side? I'm just curious about the performance.

Marc Parent, President & Chief Executive Officer

No, no, I would -- sorry, to interrupt you, Fadi -- look, I think as a general rule, the outlook that we've given for the back half, it's slightly steeper than normal. And particularly when we talk about Civil, I'd say we're not yet in a normal environment. As I've said in the call, China is still really not reopened. So that's putting a lid on things there.

But what you're seeing in the back half is us, first of all, seeing the benefit of all the simulator orders that we've signed this year. We've had an ordinary share of orders there, very happy to see that. And so we're seeing a lot of that order take translating to deliveries in the back half and specifically in the fourth quarter. So I have very high visibility on that.

Plus we're ramping up capital that we've already deployed in terms of simulators in both the commercial and business aircraft training networks. And specifically, as I mentioned in my remarks, you see that in the past months, we've opened our new Las Vegas business aviation training center, you'll see us very shortly open our Singapore business aviation training center. So all those factors and the order intake -- look at the order intake again this quarter at 1.48 times, both sales and civil, on top of revenues that are 40% higher year-over-year. So I think that's all -- that is what's translating the growth that you're seeing.

Fadi Chamoun, BMO Capital Markets

Okay. Great. One question on the defense side, if I may. We get a lot of this kind of question from investors, are there in the backlog other contracts like this CAE legacy contract that you had last quarter, where you are still expecting renewal maybe contracts that are not performing to your expectations and you're still expecting renewal, or is this kind of all behind us at this point?

Marc Parent, President & Chief Executive Officer

Look, if you're referring to the charges -- and I think you are -- that we recognized in the first quarter, as I think I said at the time, I really see those as unique and one-off in nature. They're really not typical of the risk profile of our business. And I've been, as you know very well, I've been at the business 17 years. And it's the first time that I've ever seen charts like that hit our P&L in a corner like that. It's not that we don't manage programs that are on watch; we've landed hundreds of programs. Some have higher margin than others, but we manage them well.

So obviously, an event like this forces you to look closer, and you'd be foolish not to go back and even enhance your level of scrutiny. And of course, we've done that and I've been part of a lot of that. But specifically to your question, I don't see any similar risk in our backlog of programs, certainly not ones that we see at this time.

And to give you some more colour, in terms of conditions of contracts that we're bidding these days, and the discipline that we're applying to those bids, it gives me a lot of confidence in our current leadership team and the expected margins that we'll be able to execute on those contracts.

Fadi Chamoun, BMO Capital Markets

Okay. Thank you.

Operator

Thank you. The next question comes from James McGarragle, RBC. Please go ahead.

James McGarragle, RBC

Hey, everyone. Thanks for taking my question. I just had a quick question on the increase on the defense backlog and some of the new contracts you're bidding on. Do you have any protection for any potential supply chain issues on those new contracts? I think supply chain it's very uncertain as to when things are going to get better. And if supply chain issues were to persist, just for another year, another two years, could we see any risk to margins with those contracts that you're bidding on, or is there some protection kind of being built into those new agreements that you're working through right now?

Marc Parent, President & Chief Executive Officer

Well, you can be sure that the contracts that we're bidding now take into account the situation that we see now, including issues as continued inflation at the levels that we've seen. And the customers, by and large, understand that reality. So just a contract that I reviewed the other day where a fairly major contract where typically, as in previous contracts, what you would have seen, you have seen fuel being an element that we would cost it there.

But with the price of fuel, the way it's escalated and the unpredictably of it, the customer themselves don't want us to bid to cover ourselves because we bid at a verified rate to cover ourselves. So what you see is specifically in that contract, which is, I think, a very good example of the kind of things that we see is we bid it basically with that component as an ODC, or other direct cost.

So it means it takes it out completely. It neutralizes it totally, and that's what you see happening. And by and large, in the previous answer, I was talking about this, that we're seeing a shift in contracts that's certainly the ones we're bidding on going from really lowest price wins, what's called lowest cost technically acceptable contracts to best value in the United States Defense Department.

So I'm pretty confident that first of all, that the programs that we're winning that earn a backlog, certainly in the last five quarters where we've seen this strong backlog increase, are at profitability levels that support our objectives for low double-digit profitability. And I am quite confident we will execute them at that margin profile.

James McGarragle, RBC

I appreciate that. And my next question is on the civil business and the recovery there is obviously predicated, obviously, recovery to pre-pandemic travel. I know you don't operate in China, but your Asia business is affected by what goes on in that country. So how that country's Zero COVID policy affected your recovery? How are you managing through that uncertainty going forward?

Marc Parent, President & Chief Executive Officer

Well, I think, I would start by saying is when you look at the margins that we're seeing right now without China and the Asia market really being back, we're back to margins that are near pre-pandemic levels at near 21%. And what you're seeing -- and obviously at a lower level of revenue than we saw pre-pandemic -- that's just showing you the cost savings that we've taken out of our network coming to fruition. So expect as the recovery continues to progress -- which we fully expect that it will -- expect further margin progression in that regard.

But going back specifically to your question, the way China affects us is historically, we've had a very high market share of selling simulators in China. I expect that that will continue, that the market is low right now. So we're not selling a lot of simulators in China. Right now, nobody is.

As I look at how else does that China situation affect us, is that all of our training centers in Asia Pacific, the anchor customers that we have, they're training those locations, a lot of their flights are to and from China every day. So that, obviously, affects the amount of flight activity and therefore, the amount of training activity, and that's why -- that's where there's a lot of expected recovery in that regard.

James McGarragle, RBC

I appreciate it, and I'll turn the line over. Thank you very much.

Operator

Thank you. The next question comes from Konark Gupta of Scotiabank. Please go ahead.

Konark Gupta, Scotiabank

Thanks, operator and good afternoon, everyone. I just wanted to first, I'm trying to make sense of the defense SOI for second quarter, which was, I think, $18 million, still kind of down below the normal levels that you had before the last quarter.

So I understand you have supply chain issues you mentioned and the labor issues and some order delays and all those things. But would you say, like, even if you strip out those issues, the contract adjustments that you took in fiscal Q1, that would have still like showed up at the new margin level in fiscal Q2, and that should continue.

I'm like -- I'm just trying to understand like how defense SOI can go from 18% in Q2 to like significantly higher numbers in Q3 and Q4.

Marc Parent, President & Chief Executive Officer

Well, I think, I'd start by saying our Q2 performance was as we expected it to be. And as I said it would be on the last call, sequentially ahead of last quarter. Of course, adjusted for the discrete charges that we saw in Q1, which are, as I said, one-off.

Look, we're not alone in this. Like our peers, we continue to feel the effects, some very real labor and supply challenges across the industry. And I think we're managing them well. But as well, we do see select award delays on order intake.

So we're continuing to work these, and it's specifically with regards to labor and supply changes, the way we're managing and of course, as they affect our company, we see these abating by the year-end, not going away totally, but certainly abating.

And that's where you're seeing that plus specific orders that we see coming in that we have high visibility on, gives us the confidence that we can achieve the ramp-up in defense numbers in terms of profitability in the third and especially in the fourth quarter.

Now of course, one thing that I think, like me, you'll be excited about is the order intake, which continues to be very strong, you got five quarters of book-to-bill higher than one with 12-month trailing book-to-bill at higher than 1.3, that really points to a strong and improved performance in the future.

Konark Gupta, Scotiabank

Okay. That's helpful, Marc. Thanks so much. And then one more for perhaps for Sonya. I think in your comments, you mentioned that you want to reinstate shareholder returns over time. So like a two-part question there, does that mean dividends or buybacks? And would you have to wait until the leverage ratio going down below three times before you reinstate those things?

Sonya Branco, Executive Vice President, Finance and CFO

So as we mentioned, our first priority is to de-lever. And we continue to be on track to bring our net debt to adjusted EBITDA down to below three times by mid next fiscal year. And then, we believe, we'll then be in a position to consider return of capital to shareholders.

So too soon to really speak to the form, but with the added, you know, once we reach kind of a normalized balance sheet and the financial flexibility, we'll turn to returning capital to shareholders.

Konark Gupta, Scotiabank

Okay. Thanks, Sonya.

Operator

Thank you. The next question comes from Kristine Liwag of Morgan Stanley. Please go ahead.

Kristine Liwag, Morgan Stanley

Hey. Good afternoon, everyone.

Marc Parent, President & Chief Executive Officer

Hello.

Kristine Liwag, Morgan Stanley

Hey, Marc, maybe circling back on Defense, you've highlighted some of the puts and takes there. But can you provide a more detailed bridge on how you get from 4% margin where the business is today? And how you get to a high-single digit or potentially low-double digit at some point.

How much of this margin expansion is a function of lower margin contracts rolling off or better execution or better volumes absorbed from overhead or anything like that? Any more detail would be appreciated because it seems like there are a lot of moving pieces in terms of that recovery?

Marc Parent, President & Chief Executive Officer

Well, I think the components are exactly what you said. If you look at our business and we've been talking about this for a while, we've just come up, before the five quarters of book-to-bill higher than one. We, three years before that we were at book-to-bill below one. So we're running out of backlog that's inherently inefficient, by itself. COVID affected us.

We are working through labor supply chain challenges that the industry itself is facing. So for us, it's really rolling off contracts that are lower profitability, replacing them with contracts that we've been winning again going back to the order intake, and the orders that we're winning are accretive to the objectives that we have of low double-digit return on the operating income.

And so, look again, I said, continue to watch order intake. So order intakes the one to watch and I've been saying this for a few quarters now, and order intake is very, very good. We're, as I said we're bidding more, we're building larger. And just look at, we've now got outstanding business proposals of $8 billion, which is a very substantial increase. So all of those other factors that are going to be that bridge that you're looking for.

Kristine Liwag, Morgan Stanley

I see. And then Marc would you quantify on how much of that lower margin defense revenues rolling off this year to help us with modeling?

Marc Parent, President & Chief Executive Officer

We can't be that specific really at this time. Sonya, have anything you would add?

Sonya Branco, Executive Vice President, Finance and CFO

No.

Marc Parent, President & Chief Executive Officer

No. I think we'd have to leave it to what we've said already.

Kristine Liwag, Morgan Stanley

Great. And if I could add one more maybe on a commercial, you've taken up your restructuring costs, going forward can you share the magnitude of what these costs would entail next year? And also, when you think about the once you fully realize the cost benefits of these actions how we should think about incremental margins?

Sonya Branco, Executive Vice President, Finance and CFO

So Kristine, I'll take this one. But the restructuring program is ended. So the costs are behind it. It ended in Q1. And as you can see it's being realized already as we see it sort of go through the civil margins, right, as we have committed to $70 million plus of recurring structural savings and we see it, and we see it in those margins.

What's up in those accounts is really the integration costs of the major acquisitions. And on the L3Harris military training that will be trailing off in the second half and Air Center will continue the integration for the next two quarters.

Kristine Liwag, Morgan Stanley

Great. Thank you, Marc. Thank you, Sonya.

Operator

Thank you. The next question comes from Anthony Valentini of Goldman Sachs. Please go ahead.

Anthony Valentini, Goldman Sachs

Hey, guys. This is Anthony on for Noah. How are you?

Marc Parent, President & Chief Executive Officer

Hello. Good. Thank you, Anthony.

Anthony Valentini, Goldman Sachs

I just wanted to focus on the Civil segment for a second. If I'm looking at the metrics correctly here, it looks like the simulator deliveries were flat quarter-over-quarter, utilization was down, and there's less simulators in the network, yet revenues were up 6% sequentially. So, can you just like help to bridge that for me?

Marc Parent, President & Chief Executive Officer

Well, I think maybe Sonya could give you some more color, but I think as I've said in the past that, first of all margins and utilization aren't perfectly correlated. And you see a lot of mix not all simulator orders are created equal either. They can depend quite substantially from one quarter to next just specifically, for example, if the data supplied directly by the airline as an example. So, maybe Sonya you want to expand, or anything to expand on that?

Sonya Branco, Executive Vice President, Finance and CFO

Yes, absolutely. So, despite the deliveries being flat I think product mix was favorable; it was even more favorable in the quarter and mix matters in terms of the training as well. So, less seasonality on the business jet side than the commercial side. So, that helps the margin.

And you spoke to the sims in the network while the absolute number of sims was lower because we did a bit of a rationalization, the SUs which drives the revenue so which simulators are active for revenue generation actually went up quarter-to-quarter.

Anthony Valentini, Goldman Sachs

Okay, that's helpful. And in terms of the mix, can you guys comment on the amount of deliveries that are wide-body and the amount of orders that you guys are getting that are wide-body versus narrow?

Marc Parent, President & Chief Executive Officer

We don't actually break it out, frankly. We don't actually have that data. We don't break it out that way.

Sonya Branco, Executive Vice President, Finance and CFO

Yes. We don't necessarily break it out but you can assume that it's mostly narrow-bodies.

Anthony Valentini, Goldman Sachs

Okay, great. And then last one on this for me is how much is the revenue and SOI contribution in the quarter from Sabre?

Marc Parent, President & Chief Executive Officer

7% revenue.

Sonya Branco, Executive Vice President, Finance and CFO

Yes. So 7% of civil revenue so that equates to about $35 million and a pretty strong accretive margins to the business.

Anthony Valentini, Goldman Sachs

Great. Thank you so much.

Operator

Thank you. The next question comes from Michael Kyperos, of Desjardins Capital Markets. Please go ahead.

Michael Kyperos, Desjardins Capital Markets

Hi, thank you for taking the question. Maybe just on the announcement with the Qantas and Virgin. Do you expect further outsourcing of training across the airline industry given that they're facing higher costs right now in other parts of their business?

Marc Parent, President & Chief Executive Officer

Yes. I think this is a continued good time for the future for outsourcing as we predicted all along. Look, it's just a natural evolution of the business. There is only real global third-party way to be able to do training and we're the largest training network in the world, training over one million hours a year. So, we provided a huge synergy there and huge benefits to airlines that want to do it.

So, yes, I continue to see more opportunities out there. We announced the big ones like you're talking about Qantas, but there's a lot that we will do overflow training and that's been a factor as well. And we're putting simulators out there on contracts to do just that. And when we do that, we get long-term contracts that's going to be good going forward. So, I continue to see that as being a trend going forward.

Michael Kyperos, Desjardins Capital Markets

Perfect. Thank you. That's great color. And maybe just on the fixed-price contracts. I saw Boeing at their Investor Day came out and said that going forward they have no longer appetite for fixed price programs. Maybe just your opinion in the industry aerospace industry as a whole: do you share that view and if the industry is maybe stepping away from that moving forward?

Marc Parent, President & Chief Executive Officer

Look, I can only comment about us. We bid on a contract that fit our strategy and the capabilities that we have and a lot of them are fixed firm price contracts and we're good at executing those kind of contracts.

As I said, notwithstanding what happened and specifically for one-off reasons last quarter, we have a very good track record going over multiple years. And I'm very confident that we're going to execute contracts that are fixed firm price in the future.

And I think going back to what I was saying a while ago on a previous answer, what we see specifically in the US market is a shift to best value contracts. And that is very positive for CAE with our specific differentiation in the market. And I think the last thing to say is again as has been answered to previous question, the government wants to create an environment in which case the risks are well managed. And I was using an example of fuel prices that taking that out of the equation. So I think that to summary we'll continue to bid on contracts and whether fixed firm price or not and we'll execute them well. I'm quite confident with that.

Michael Kyperos, Desjardins Capital Markets

Thank you. I appreciate it.

Operator

Thank you. The next question comes from Say (ph) Lee of Odlum Brown. Please go ahead.

Fai Lee, Odlum Brown

Hi. Thank you. It's Fai here. Just a clarification on the Civil utilization rate. The sequential decline of 71% last quarter, it's not 66, is that declining due to seasonality, COVID, or are there some other factors involved there?

Marc Parent, President & Chief Executive Officer

Mainly seasonality.

Fai (ph), Odlum Brown

Seasonality. Okay. Okay. And in terms of looking longer term at the utilization rate I think prior to COVID around the mid-70 range. Is that -- do you expect to get back to that kind of range longer term, or do you expect it to be higher or kind of lower?

Marc Parent, President & Chief Executive Officer

I can't see any reason why not. We're operating in the US at a much higher rate than that right now. And so look, there's no natural reason why that was up. There’s going to be a link -- as it always is -- to the amount of flying that is done by the airlines and business aircraft. And that's gonna bring a higher rate. As I say business aircraft stabilizing at flight level, flight activity about 20% over prior to COVID period. And I see that continuing.

So I think that's going to be pretty good. And historically, I think the reason I use that example of a business aircraft is usually that will be a lower utilization by the very nature that we don't train as much on a back end of the cockpit (ph) like in business aviation. So inherently brings the utilization level down even though it's still very good revenue.

Fai Lee, Odlum Brown

Great. Okay. Thank you.

Andrew Arnovitz, Senior Vice President, Investor Relations & Enterprise Risk Management

Operator, I want to thank members of the investment community for questions. And now we'd like to open the line to members of the media for any questions from media. Please go ahead.

Operator

Thank you. As a reminder, if you would like to register a question or comment, please press the one followed by the four on your telephone. Once again, to register a question or comment the one, four. One moment please. Got it. Okay. Thank you.

The first question comes from Stephen Rolland of La Presse Canadienne. Please go ahead.

Stephen Rolland, La Presse Canadienne

Oui, bonjour monsieur Parent, merci de prendre ma question. Je voulais voir avec vous, les résultats sont très bons, le secteur de l'Aviation civile aussi, les gens continuent de voyager malgré l'inflation. Est-ce que vous avez vu dernièrement les signes d'un ralentissement du côté de l'aviation?

Marc Parent, President & Chief Executive Officer

Non, on ne voit pas de signe de ralentissement. Au contraire, on continue à voir la croissance et on peut voir comment ça se manifeste dans nos résultats. Nous avons de très bons résultats, une augmentation de nos résultats Civil de 40% d'augmentation de nos revenus, et 60% d'amélioration de nos profits en surplus. Nous avons eu une augmentation de ratio de ventes et de commandes de 1,46% ce qui veut dire qu'on continue à augmenter notre carnet de commandes de façon très significative. On ne voit pas de ralentissement en ce moment, ça c'est sûr.

Stephen Rolland, La Presse Canadienne

Ok. Je sais que vous l'avez expliqué un petit peu en anglais, les résultats ont été meilleurs que ce à quoi s'attendaient les analystes. C'était un peu plus difficile avec la chaîne d'approvisionnement et les charges que vous aviez prises avec la Défense. Qu'est ce qui a changé en trois mois et qui fait en sorte que vous êtes en meilleure posture?

Marc Parent, President & Chief Executive Officer

Les résultats sont les résultats auxquels on s'attendait. On a encore des défis qui sont des défis pas juste de CAE mais de l'industrie au complet, dans le secteur de la Défense, en ce qui a trait à la main d'œuvre et en ce qui a trait à la chaîne d'approvisionnement. Ça a continué à nous affecter dans le second quart et ça va continuer à nous affecter. On voit quand même du côté CAE que les effets vont aller en s'amenuisant vers certainement notre quatrième quart. Pour nous, c'est vraiment comme ça que ça nous affecte mais nos résultats, de façon séquentielle dans le deuxième quart, étaient les résultats auxquels on s'attendait.

Stephen Rolland, La Presse Canadienne

Ok. Dernière question: quand vous dites que vous prévoyez que ça va s'améliorer au quatrième quart, est-ce que c'est le ralentissement de l'économie qui fait que c'est plus facile de garder vos employés? Qu'est ce qui fait en sorte que vous pensez que ça va s'améliorer?

Marc Parent, President & Chief Executive Officer

Ce sont nos efforts particuliers. L'effet pour l'industrie au complet c'est celui de la main d'œuvre et celui de la chaîne d'approvisionnement. Quand on regarde dans les mois qui viennent, on peut voir nous comment est-ce que nos besoins en main d'œuvre vont être satisfaits, nous avons une belle visibilité là-dessus. C'est la même façon pour les pièces. Quand on regarde ça 6 mois à l'avance, on est capable de prévoir qu'on va être capables d'effectuer nos programmes parce qu'on va avoir la main d'œuvre et on va avoir les pièces à ce moment-là. C'est pour ça qu'on est capables de donner cette prévision-là.

Stephen Rolland, La Presse Canadienne

Ok. Merci d'avoir pris mes questions.

Marc Parent, President & Chief Executive Officer

Merci.

Operator

Merci, c'était notre dernière question. That was our final question. I'll turn the call back over to our hosts for any closing remarks.

Andrew Arnovitz, Senior Vice President, Investor Relations & Enterprise Risk Management

Thank you, operator, and thanks to everyone for joining us on the call today. I'd remind you that a transcript of today's call will be located on CAE's website for future reference. With that, I wish everyone a good afternoon.

Operator

Thank you. This does conclude the conference call for today. We thank you for your participation and ask that you please disconnect your lines. Thank you and have a good day.
