CORPORATE PARTICIPANTS

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President & Chief Executive Officer

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CONFERENCE CALL PARTICIPANTS

Fadi Chamoun
BMO Capital Markets

Kevin Chiang
CIBC World Markets

Cameron Doerksen
National Bank Financial

Turan Quettawala
Scotiabank

Benoit Poirier
Desjardins Capital Markets

Tim James
TD Securities

QUESTION AND ANSWER SESSION

Operator

And we'll get to our first question in the line from the line of Fadi Chamoun with BMO Capital Markets. Please go right ahead.

Fadi Chamoun, BMO Capital Markets

Thank you. Good afternoon and congratulations on the good results.

Marc Parent, President & Chief Executive Officer

Thank you.

Fadi Chamoun, BMO Capital Markets

I wanted to ask first on the civil side, the guidance, is this off of the base of, ah, restated EBIT base of $311 million?

Sonya Branco, Chief Financial Officer

Yes. So, the guidance is based on the normalized, which excludes the transactions during the year, and restated for IFRS 15, so all of the guidance that we have provided is on an apples-to-apples basis, so on the restated FY 2018 numbers.

Fadi Chamoun, BMO Capital Markets

Okay. And so, I mean this year you had a pretty decent conversion from revenue to operating income in civil, I think, revenue growth 5, operating income growth was 12, almost twice the conversion we've seen in the prior three years. Was there something specific helping this year?

And secondly, related to that, what can this segment do in operating margin ultimately as you continue to benefit from the strong cycle? Can we see a 20%, 21%? Like what's the possibility on the operating margin in this segment?

Marc Parent, President & Chief Executive Officer

A lot of it comes from the utilization. Increase utilization, Fadi, that does it. You look at, for example, 82% back in this latest quarter, that obviously has an effect as we throw more revenue at quasi fixed cost assets. The other thing that comes into play, which holds promise for margins in the future, is the extra yield provided by throwing more revenue off the same assets, not only utilization but by us doing wet training. And that's a goal we've had and we've been successful this year. And finally, mix is a big issue, because we have a number of components in the business depending on, you know, so utilization comes from business aircraft rather than the commercial, and even in commercial there's different parts of the world.

So there are a lot of things that play and that explains that, most of them positive this year, as you've seen. And yeah, I think, for the future, I think we just basically take it to our outlook in terms of the income growth. That's really what we should focus on. Not that margin is not important, we're quite happy with those margins, but I think we really hang our hat on SOI percentage growth itself, because we have a better view on that one with any precision and really that's really what comes into play when you look at return on capital employed of course.

Fadi Chamoun, BMO Capital Markets

Okay. Just one quick one on the CapEx, I mean you have generated more cash flow in the last couple of years than what the market opportunities to invest have been and your balance sheet is pretty strong at this point. Are you seeing more opportunities to grow or to invest for growth or is there kind of an opportunity here to look at distribution a little bit differently in the next year?

Marc Parent, President & Chief Executive Officer

Well, I mean our priorities don't change, which is always that growth is number one, and your answer to do I see more opportunities, yes, and accretive opportunities, and we look at them specifically on that and I think our results on the return on capital employed growth proves that we're focusing on that in accretive nature and, yes, we see more opportunities out there. I think I signalled that before, but I'm seeing more of an appetite for airlines specifically to want to do turnover more of their training to us specifically, and I don't see that abating.

So I think there will be opportunities for us but, you know, sometimes they are episodic, we can't predict exactly when we might close them, but on a large, on a macro base, I think there are opportunities for us to do that. And of course still maintain kind of distribution that although, you know, never really a guarantee, but you've seen our pattern on distribution, on cash returns to shareholders now with the dividend and the buybacks that we've done. I don't see any reason to expect that we will change that materially, but we'll see. We'll see. Depending on how successful we are on deploying that cash, you know, we'll hold our powder dry and take it when we get to that point. But coming back it, there are opportunities in the market for us to deploy that capital accretively.

Sonya Branco, Chief Financial Officer

And just if I may add, like Marc said, we continue to see good market opportunities. And the assets that we've deployed so far in last few years that are market led have ramped up quite quickly to generate accretive returns, support growth, and just to the recurring cash flow generation. So, to the extent we continue to see that, we'll continue to do so, to invest. And we often look at the CapEx as an absolute number, absolute value, but the company has grown. And if we look at it from a capital intensity perspective, the CapEx as a proportion of operating cash flows, the intensity actually is decreasing. And so the investment and growth continues to be our first priority. Of course, we always balance it with a view on the return to shareholders and, as Marc mentioned, pretty good track record with seven years of dividend increase and some NCIB in the year and $135 million of cash returned to shareholders this year, which is a 10% increase year over year.

Fadi Chamoun, BMO Capital Markets

Okay. Thank you.

Operator

Thank you very much. We'll go to our next question on the line. It's from the line of Kevin Chiang with CIBC. Please go right ahead with your question.

Kevin Chiang, CIBC World Markets

Hi. Thanks for taking my question and congrats on a good quarter there and good end to the year.

Maybe just following on Fadi's question there around where margins can go, you spoke about the opportunity to improve yields, shifting from dry hours to wet hours. With your utilization at 82%, are you finding it—are you able to accelerate that shift, I guess, to improve that yield given your utilization is so high now? Are you able to push it or is it more fluid and it kind of comes and goes depending what the customer chooses from your service offering?

Marc Parent, President & Chief Executive Officer

Well, I think it does. I mean 82% is high. Can you get higher? I guess, theoretically, yes, because 100%, we define 100% depending on the market like 6,000 hours in commercial aircraft, for example, 4,500 hours on business aircraft a year. But I can tell you, and I've said this is in the past, that some of our training centres are operating significantly above 100%. So, is it possible? Yes. But, of course, our training centres are regionally distributed all over the world and we've had a pretty good market, so it really depends on how the market continues to grow across the world. That really is part of the answer on utilization.

And more than that, as well as you were saying just in your question, the mix of customers, like for example, business aviation, in the past, if we go back, I mean business aviation is a bit, is a little bit better than we've seen in the past, recent past anyway, but it's still nowhere near the level it was prior to the financial crisis of 2008. So, if we see business aircraft coming back in any material way, then that could have a quite significant benefit to not necessary margin growth, margin growth, yes, but operating income growth.

Kevin Chiang, CIBC World Markets

That's helpful. And maybe just a quick one for me on healthcare. I noted in some of your disclosure you talked about a lower R&D is helping boost operating income. Should I read that as a sign that you've hit maybe a maturity level within your product profile there and maybe, conversely, a sign that fiscal 2019 we should start seeing maybe a more significant improvement in profitability within healthcare? Is that something we can look forward to over the next kind of 12 to 18 months?

Marc Parent, President & Chief Executive Officer

Well, we're focusing on growth in healthcare. That hasn't changed. We believe the potential for the market is significantly larger than the business we have today, the market opportunity, and a lot of it has to do with gaining share in the markets that really hold a large pool of value today that's being served today like, for example, nursing. So we've launched new products, CAE Juno specifically, at that. The market receptivity to that product has been very good.

To your question about R&D, no, we haven't taken our foot off the pedal. We continue to invest both there and in SG&A, mainly sales force marketing expenses, to continue to grow the business. But with top-line growth, bottom-line growth will come because, as I've said in the past, that the margin of the products we have is very good, I would say. So we room to do both top and bottom and that's our expectation.

Sonya Branco, Chief Financial Officer

And to add to that, so the R&D expense did go down a little bit this year, but really it's a reflection of the cycle we were in some of our product development. So you'll note that the capitalized R&D is higher because we were in development mode, because we did launch quite a few products this year. So that R&D expense did go down, but what I would argue is it got replaced with added investment in our product launch, expenses, marketing, and also on the SG&A in our sales force to launch this new products.

Kevin Chiang, CIBC World Markets

That's very helpful. Thank you for the colour.

Operator

Thank you very much. We'll go to our next on the line. It's from the line of Cameron Doerksen with National Bank Financial. Please go right ahead.

Cameron Doerksen, National Bank Financial

Thanks. Good afternoon. Just to follow-up on Kevin's question on the healthcare, I think one of the things you cited also in the margin in Q4 was a re-measurement of royalty obligation. I'm just wondering if you can describe that impact was. I guess what I'm trying to get a sense of is what's kind of a more normalized margin for healthcare at this type of revenue level at $35 million, because obviously revenue is going to continue to track higher and I want to get a sense where the margins can go.

Sonya Branco, Chief Financial Officer

So there was a benefit in the quarter from kind of one-time lower royalty expense, so there was a bit of a bit of the benefit in the quarter, but over the year, and as I just mentioned, we did invest lot of one-time costs and SG&A and product launches. So, over the year, the benefit is basically is neutralized. So the way that I will look at it is over the annual year, the growth in revenue and the growth in SOI, as little bit more indicative. But, of course, this is a business that has pretty good gross margin and so we are continuing to invest in products and launches and SG&A, but as we grow volume we should see that dropping to the bottom line and to the SOI.

Cameron Doerksen, National Bank Financial

Okay. Just a quick question on defence. I mean obviously there's a terrific pipeline of opportunities there for you. I'm just wondering if you can maybe just talk about any potential sort of larger, longer-term training contracts that you have currently that might be up for re-bid. Is there anything that's at risk in the current revenue stream on defence for this year?

Marc Parent, President & Chief Executive Officer

We've a number that will come out over the next few months, when I saw the next few months, a year and a half approximately, that are specific coming up. I can think of, and I have to look in detail here, but I think the KC-135 contract is coming up over the next couple of years, initial (inaudible) date. Also the training that we do for the unmanned air vehicles, the Predator and the Reaper, that's up for rebid, I think, in the next year, next few months I believe. I'm just consulting my notes as we go here. But, actually, I'm just told that KC-135 is not this year. Predator/Reaper is this year. So those are the ones I can think of.

But, having said that, we think we have a pretty good shot as the incumbent on those programs, but it will be competitive. There's no doubt about that, because they are good contracts. But, at the same time, there's a lot of contracts that are coming up for bid in other areas, like for example, you know, I'll just pick one, the C-17 in the United States that's coming up, and we, as I said, we have about $4.5 billion of active bids that have been submitted and we're waiting for decisions on those. I think you take all of that, basically is the nucleus of the outlook that we have for defence this year.

Cameron Doerksen, National Bank Financial

Okay, no, that's great information. Thanks very much.

Operator

Thank you very much. We'll get to our next question on the line. It's from the line of Turan Quettawala with Scotiabank. Please go right ahead.

Turan Quettawala, Scotiabank

Good afternoon. Thank you for taking my question and congratulations on a great quarter there. I guess I wanted to just ask, firstly, on the gains. Is it possible, Sonya, to divvy those up between the segments?

Sonya Branco, Chief Financial Officer

So, not much in the quarter; in fact, in that other gains and losses we had a bit of a headwind with FX. The most significant item was essentially a gain on the disposal of an asset in civil and from our network to a customer. And that, we regularly meet customer needs, either through new simulators, kind of partial builds, of course custom, or from our network, so we consider it part of our normal course operation. It's simply accounted for out of fixed assets rather than inventory. So that would be the larger item.

Turan Quettawala, Scotiabank

That's helpful, thank you. No. I understand that, I'm just trying to figure out the segment numbers there. That's helpful, thank you. And I guess, maybe just one more question for me here in terms of, you know, as you look at the outlook here and we look at sort of all of the segments, things seem to be doing really well on all the segments for the most part. Marc, is there something that you're worried about in terms of a risk? What do you think could go wrong here, potentially?

Marc Parent, President & Chief Executive Officer

Well, I mean, obviously, giving you the outlook for a public company, I'm pretty confident in the outlook, obviously, but there's always risk, there is, and the risks are the usual ones of competition. And, for example, I was just talking on the previous question with Cameron on the defence bids. I mean, yeah, we've active bids, but although we have a very large backlog there's still a not insignificant portion of the SOI that we'll have to generate this year that's going to come from the wins we'll win this year. So, clearly, we've to win them.

But, having said that, talking out of both sides of my mouth if you like, we have backup plans to make sure we do. So that's part of the risk, I would say. Otherwise, there's competition in civil as well. There are a lot of players like CAE in the same market as we do, so they will be aggressive, and there's price competition. So those are the usual ones. So we expect that we are going to continue to be able to win our fair share and I think, barring any black swan events that we can't control, I think it's mainly competition that is the real issue here.

Turan Quettawala, Scotiabank

That's really helpful. Thank you very much. Congratulations.

Marc Parent, President & Chief Executive Officer

Thank you.

Operator

And we'll proceed to our next question on the line. It's from the line of Benoit Poirier with Desjardins Capital Markets. Please go right ahead.

Benoit Poirier, Desjardins Capital Markets

Good afternoon and congrats for the good quarter. Just to come back on the bidding proposal, I mean it's been up from $4 billion to $4.5 billion. Could you talk a little bit about the mix inside? Just want to get a better understanding of the mix between equipment and services. I know the focus is on TSI, but trying to gauge whether we could see some margin expansion from the 11.8% EBIT margin you achieved in fiscal 2018.

Marc Parent, President & Chief Executive Officer

I don't have the exact—and actually, the number, I think we said $4.5 billion, but it's more like $4.7 billion, but I mean within the spitting distance there in terms of the bids we have out there. Look, I can't tell you offhand with precision right now, maybe we'll get back to you on the... In fact, I don't even know if we ever put that out, the split between products and services. Do we?

Andrew Arnovitz, Vice President, Strategy & Investor Relations

Yeah. I think, Benoit, you should assume that it's going to profile pretty much like the other TSI deals that we have brought in and, as examples, where there is usually a long, sort of long-tail services component. And it's one of the reasons why really our guidance, our outlook continues to be based on operating income dollar growth as opposed to margin specifically, because depending on how these programs flow through in product service mix will be as much or more of a determinant of margin percentage than anything else. And as we look at our backlog in aggregate in defence, it's probably about a 12% backlog, if you could process it all at once, which you can't, and so the variations you see from quarter to quarter are really described mainly by the differences in product service mix.

Benoit Poirier, Desjardins Capital Markets

I see. Okay. That's interesting. And when we look at civil, you finished the year with 50 orders and you're off to a good start, so any thoughts about what type of numbers we could expect for the full year in fiscal 2019, Marc?

Marc Parent, President & Chief Executive Officer

At this point I would say, look, prefacing my answer I would say the dynamics haven't changed, it's really the amount. We expect to continue to win, to be a leader in this market, like I would say 60%, 70% market share. We do like to make money when we sell these, so that's why Boeing's saying 60% to 70%. But, it's really based, ah, the catalyst there, as you know, is really the production rates at the OEMs. And the production rates at OEMs are still very high and they have, they're not going to change materially during this year, so I'd expect in the 40s. That's what I would expect at this juncture.

I can't give you a lot more precision on that, because a lot of it depends on multi-year purchasing. Like some of the ones we won last year are sims that people are ordering that they're going to cover for next three years. So, depending on the mix of customers we have, it really depends are they buying for the next couple of years or are they buying for the next ten. So that's what really it will depend on. But, at the moment, I think last year we pretty much said that and we'd rather stay on the right side of that answer, if you know what I mean.

Benoit Poirier, Desjardins Capital Markets

Okay. Okay. Perfect. And lastly, when we look at the US, it seems that there is pretty nice opportunities in 2018 looking at the TX, the MQ-25, Boeing also with the MoM, so I was wondering whether you could talk a little how CAE's positioned on those opportunities and whether it's part of the $4.7 billion proposal out there that you talked about.

Marc Parent, President & Chief Executive Officer

Well, I don't want to really get into too much detail of what's in that, because some of it is confidential, that we don't actually say what we bid on in all cases. I would tell you it's very international. It's not only United States. Although the pipeline of opportunities in the United States obviously is very good, because the US is the biggest defence market in the world and the budget's just been announced and it's the largest budget they've had. So that's all very good.

Another noteworthy thing is I think we'll—CAE is now able to bid on top-secret programs, which we haven't been in the past, as a result of us recently obtaining what's called a proxy, which really allows us to go after, again, top-secret programs. So that opens up another part of the market for us that we haven't really been able to access before. So I think that will be good for us.

Benoit Poirier, Desjardins Capital Markets

Okay. And lastly, in terms of, ah, I mean, financial leverage, obviously you finished the year on a strong note. The focus obviously is on growth. You highlighted the CapEx guidance for this year. But when we look at the free cash flow generation also, should we assume that the debt levels will go down much further still in fiscal 2019? Or any opportunities to, let's say, deploy capital outside the $200 million you are looking to invest in fiscal 2019?

Marc Parent, President & Chief Executive Officer

Well, I'll let Sonya provide a more detailed answer on the leverage, but we see growth. I mean the $200 million is based on our assessments of the opportunities that we've imminently in front of us right now, either that we've approved, that we've launched, or that has a very likelihood of happening. Now, over the next few months I could see other things happening. If we get, for example, a big opportunity for outsourcing an airline and that makes sense to us, well, that may increase our CapEx. That's just an example.

So, with that, I'll maybe just turn it over to Sonya.

Sonya Branco, Chief Financial Officer

Yeah, just to add, we continually—this is our best view of our opportunities but as they firm up or as additional ones come up, there could be opportunities for additional CapEx, whether it's a straight-up CapEx (inaudible) or, you know, we continue to have conversations on a good pipeline of outsourcing, and that we treat kind of like M&A. So, that affords us that flexibility, should it be under JV format or otherwise, to deploy some capital to deploy some larger outsourcings.

Benoit Poirier, Desjardins Capital Markets

Okay. Perfect. That's it for me. Thank you very much and congrats again.

Marc Parent, President & Chief Executive Officer

Thank you.

Operator

Thank you very much. And, before we proceed, once again, for the financial analysts on the phone, as a reminder, to register for a question it is the one four on your telephone keypad. We'll get to our next question on the line. It's from the line of Tim James with TD Securities. Please go right ahead.

Tim James, TD Securities

Thank you. Good afternoon. Just a couple of quick clarifications maybe from you, Sonya. The $200 million in CapEx planned for fiscal 2019, does that include any amounts for capitalized development costs or is that in addition to that $200 million?

Sonya Branco, Chief Financial Officer

So, the capitalized development costs would be in addition. The CapEx is really mostly deployments of simulators to support client demand and growing outsourcings.

Tim James, TD Securities

Okay. Thank you. And then returning to an earlier question that you had in regards to the civil operating earnings growth guidance for fiscal 2019, you indicated it was based on an adjusted fiscal 2018 applying IFRS 15, but when you say adjusted, does that mean... I mean there were a number of significant one-time benefits in the operating earnings in civil in fiscal 2018. Is that included in the base upon which we should think about that growth rate?

Sonya Branco, Chief Financial Officer

No. So there are two elements. So, restated for the 2018 IFRS impacts, but also normalized out. And we've provided that detail in the supplemental presentation. So there's the normalized number that removes the impacts of those transactions during the year. So the outlook is on the normalized basis.

Tim James, TD Securities

Okay, great. Thank you. Then, Marc, just you were commenting earlier regarding the opportunity that still exists and kind of where the business aircraft training market is. Could you just generally characterize the utilization of your business jet training sims? I'm trying to understand if the opportunity for growth, and maybe at some point to return to sort of historic levels, does that require putting more sims into the network or are the existing business jet training simulators in the network underutilized and you can sort of increase the revenue that you get from those assets without investing in additional assets?

Marc Parent, President & Chief Executive Officer

I think both. I think there's a level of, ah, I think it's very rare, although there are some that are full, there are definitely some, especially some of the most recent models. Some older models may not be as full but they're quite profitable because, for example, they are down the depreciation curve. But there is definitely opportunity to add more business jet sims. For sure. And that's, I think that we've added some and I think we will continue to add some to cater for the increased demand that we see out there in business aircraft.

And I think that if I look at the utilization of business aircraft itself, it doesn't give you the whole story, because it, you know, I think you've got to look at other metrics that I think tell us that there's still a lot of growth potential to bring us back to anywhere near where we were prior to 2008. Like, for example, I think, prior to 2008 I think business jets were operating north of 500 hours a year and I think now they're operating about north of like 300, 350 hours a year. But I may be precisely wrong on those numbers but you get an idea of the difference. So, if you get to any kind of utilization for aircraft higher, I mean that will have a pretty significant impact, because obviously you need more pilots.

Tim James, TD Securities

Okay. That's helpful. Thank you. So, maybe just to follow on that then, if we think about eventually, at some point in time, your business jet training revenue stream or training hours getting back to that pre-2008 level, can you do that with the existing asset base or would there be some incremental investment required to support that historic level, that pre-2008 level of activity?

Marc Parent, President & Chief Executive Officer

No, we'll probably add some. We'll probably add some. We'll fill the ones we've got and probably add some, just because there's more airplanes out there and new models and will require more sims. There's no doubt in my mind.

Tim James, TD Securities

Okay. Thank you. And then just a final question, you ended the quarter with over $600 million in cash and you kind of touched on the leverage in your capital priorities. I'm just thinking forward over the long-term here, am I correct in assuming that kind of having that amount of cash on the balance sheet is more than you would ideally like to hold over the long term? Or is that level sort of appropriate, do you feel, for the business?

Marc Parent, President & Chief Executive Officer

To be flippant, I'd say I like it. Sonya doesn't. But, no, look, our priority is growth. I'll let, ah, Sonya has talked about it. So we see opportunities but, you know, we're focused on accretiveness and we've been successful at that and the opportunities don't come, as you say, they don't come necessarily—we don't have the luxury of deciding exactly sometimes when they will happen, when customers will want to do it, when they present themselves, and whether or not it will be a good opportunity for us to be accretive. But, going back to what I said, we see those opportunities and increasingly, obviously our priority, we used to have a priority, the third priority was to de-lever. It is no longer a priority.

Do you want add anything, Sonya?

Sonya Branco, Chief Financial Officer

We'll always maintain a solid financial position but I think we're in, ah, we've the financial flexibility to be able to invest thoughtfully in accretive opportunities and I think we've proved with the investments that we've done that they are successful, they're market led. The market continues to be a demand in opportunities and to the extent that they are accretive to earnings, returns, and cash flow, I think we've the opportunity to deploy that cash into more capital.

Tim James, TD Securities

Okay, great. Thank you very much.

Marc Parent, President & Chief Executive Officer

Thank you, Tim.

Andrew Arnovitz, Vice President, Strategy & Investor Relations

Operator, that's all the time we seem to have for analysts and investors. I do want to use the last bit of time we have here for members of the media, if there are any questions from members of the media.

Operator

Certainly. Once again on the phones, now for the press and media, if you have any questions you would like to ask you can do so by pressing the one followed by the four on your telephone keypad.

Once again for the press and media, it’s the one four to register any questions or comments.

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

Andrew Arnovitz, Vice President, Strategy & Investor Relations

Okay. Well, I want to take this occasion to thank everybody who joined us here today on the call and to remind you the transcript of the call will be made available on CAE’s website at cae.com. Thank you.

Operator

Thank you. Ladies and gentlemen, that 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.
