CORPORATE PARTICIPANTS

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Desjardins Capital Markets

Kristine Liwag
Bank of America Merrill Lynch

Cameron Doerksen
National Bank Financial

Tim James
TD Securities

Chris Murray
AltaCorp Capital

QUESTION AND ANSWER SESSION

Operator

Ladies and gentlemen if you’d like to register a question, 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 1 followed by the 3. If you are using a speakerphone, please lift your handset before entering your request. One moment please for the first question,

Your first question comes from the line of Kevin Cheng, with CIBC, please proceed with your question.

Kevin Cheng, CIBC

Hi, Good afternoon, thank you for taking my question here, maybe just a clarification question in regards to the acquisition of the business aircraft training division from Bombardier. You've noted that it'll add about 100 to 150 basis points to your margin within Civil. So just wondering how that -- how I should think about that flowing through seasonally within the divisions? When I look back over the past 4 or 5 quarters, your margins runs between, let's say, 16% to 21%. Is it -- should I think of it just lifting everything by the 100 to 150 basis points? Or does it have a greater seasonal impact in the low quarters because it's more wet training involved and the top end kind of sticks around 21. Just trying to get a sense of how this works through the year for you?

Andrew Arnovitz, Vice-President

Hi, Kevin, it's Andrew. Let me see how I can help you with that. I think the way I would look at it is that our references always on an annual basis. So, when we are looking at what Civil achieves on a yearly basis figure it on about 100 basis points to 150 basis points lift from the acquisitions. Look when we've seen with our experience in business aviations that our fourth quarter tends to be a big quarter for business aviation, so not sure it's important enough to establish as a seasonal trend, but that's probably something that I would take into consideration.
Kevin Cheng, CIBC

Ok, that is helpful, and then just in terms of the back half of for the year, you've noticed some integration cost with AOCE. Are there additional I guess integration cost drags to consider in the back half or you are basically do most of that now?

Sonya Branco, Vice-President

So, the integration is progressing well and working through kind of all the synergies. We do expect some remainder in integration cost in the back half of about a 1 million to 2 million.

Kevin Cheng, CIBC

Ok, that is helpful, and just lastly for me. Just in the Healthcare, you are bouncing around 30 million in revenue pretty consistently here and I know you are very positive on, on the long-term outlook. But do you have a sense of when this revenue hits an inflection point that drives to a much improved margin profile? Or is this a situation where you are holding steady and eventually the market will come to you and you get that big revenue lift that you are expecting? Should I get a sense of -- do you have a sense of when revenue gets better? Or is this is more of a longer-term trend outlook?

Marc Parent, President & Ceo

Well, I think that our expectations are, as you might expect are reflected in the outlook that we have given, so I do expect a lift. I think what we are seeing look is that, we would have a bit of an inflection and that has occurred and occurring in our business where we have been shifting our strategy over the last year towards what we call, the larger value pool in this business, which is nursing training. So, we have basically focused our R&D and coming out with new products that were specifically destined to enter this market and also CAE Juno and CAE Ares. And those products are what we are seeing -- we see those products being well adopted by the market, we are increasing the sale of those. There are a lot of cost points is different market, less complexity, but ideal for that market. We see those progressing, but at the same time what we see is in our existing markets which is with high feudality bit more of a flat situation. So always see us overcoming the, if you like the time flow which just made me now overcoming just the time it takes to penetrate that market, it's really going after penetrating share in that market.

We are confident that market exists, products are resonating, and I think that -- again it will come up in, we expected to see the revenue follow the expectations we have in our outlook. I won't go further down the road on that one and additional years except that I continue to be confident that this is a growth story that will achieve meaning scale for CAE. So, yes, I'm still confident based on what I'm seeing, but admittedly to your point the numbers will reflect that at the moment.

Marc Parent, President & Ceo

No, it's definitely not a fluke, Fadi. I think I was in the couple of quarters at least on a call I had said that, I used to say going back two three years that when I looked at the market that we have the credibility to be able to identify a secure 1 or 2 deals like this in any given year. And that was about the market that we could see. But in the recent quarters, we definitely see more appetite for that and clearly because airlines are really concentrating on what their core business is, which is yet to efficiently fly passengers. And we've offered them a very credible alternative because that's how we do. If you think about it what we do in, our airlines is, look, it will take care of basically the pilot training parts of your operation, we're very credible at it.

We have the capability. We have the scale. And because we train, I think our recent numbers are training more in the 180,000 prior to year. We believe we've been able to develop an expertise in that. And to do that very efficiently with the throwing the initiatives that we have that we announced over this past summer, but digital innovation being able to provide unique insights to our
customers on their flight crews. And flight -- obtaining pilots these days, able to secure that capability and manage them effectively becomes that much more important when pilots orders are getting to be the norm around the world. So -- and that particular dynamic is a conversation starter at many airlines just by itself. So, it's not a fluke and I continue to see a good pipeline of those opportunities in the future.

Fadi Chamoun, BMO

Okay, I guess I wanted to ask as far as like the pipeline go, is it kind of getting stronger compared to say a year ago or two years ago? And I saw it's kind of raised your CapEx to handle almost that volume coming at you. With this acquisition, does this kind of constrain your ability to go after some larger outsourcing deal with because the CapEx need maybe significant?

Marc Parent, President & Ceo

Well, I think the latter question, I would say, look, I think as you hopefully see in a result is that the CapEx we're deploying is highly accretive very soon to our numbers, and we look at them on that basis. I think Sonya know, I would call it (inaudible), but definitely even including the acquisition that we've just announced and the CapEx that we've increased for this year, I don't think that puts a constraint on us being able to go after, definitely increased outsourcing and opportunity. And don't forget that business aircraft itself generates a high degree of cash flow, it's all wet. So, as we said and this is highly accretive pretty fast; and Sonya, do you want to add anything?

Sonya Branco, Vice-President

Yes, I just maybe to add, to add on that. So, the pro forma leverage that we've kind of guide to recruiting expected to be at 42% net debt to capital, which is comfortable within our target range for leverage. And we expect to generate some good free cash flow out of this business jet operation, in addition to our own underlying cash flow, which allows for deleveraging to the lower end of that range in 24 to 6 months. So between the cash flow generation, the strong balance sheet, it continues to provide good flexibility for us to capitalize on opportunities as they come along.

Our next question is coming from the line of Jean-Francois Lavoie with Desjardins Capital Markets. Please proceed with your question.

Jean-Francois Lavoie, Desjardins

Yes, thank you very much and good afternoon everyone. I just wanted to ask question about the contract with easyJet. You mentioned that easyJet will take a portion of your capacity at the new facility in London-Gatwick. I was wondering, how much excess capacity would have to deploy to our new trainings contract with new customers?

Marc Parent, President & Ceo

You mean Gatwick specifically or…

Jean-Francois Lavoie, Desjardins

Yes, please.

Marc Parent, President & Ceo

Well, I don't know the number of the handle. We are basically sizing a new facility there. So, we already have a facility at Gatwick, and we always size our opportunities to be, I would say, we basically walk a tight rope between having enough capacity through to be able to serve the market that's there. At the same time, we want to utilize the assets at a very high level. So, I think the short answer is, we basically size our capabilities, buildings number of simulators to the market.

If there are very large markets in Europe specifically, we have a number of training centers in Europe. So, I think we would have capacity, I can't tell you exactly how much. And frankly, I would hope it's not too much right now because exactly we'd have access that wouldn't be fully utilized. But I think what market led with whatever market is out there, you can expect to see what size itself to be able to handle it.

We could do it pretty fast because our turnaround we usually size our building and land, that's associated with them to have capacity for growth. And the way we architect our centers because as you met, we have a lot of tenders out there around the world. We architect them in a fashion that is pretty simple for us to add existing similar base by having it's like a plug-and-play to extra, if you like add next that we will have to building and we met the secured land before him.
Jean-François Lavoie, Desjardins

Ok, thank you very much. And maybe again on that contract, I just wanted to -- if you could provide the split between the incremental portion of that contract that will be for CAE?

Marc Parent, President & Ceo

The incremental -- you get that one, Sonya

Sonya Branco, Vice-President

So, the incremental growth from that contract, is that your question?

Jean-François Lavoie, Desjardins

Yes exactly.

Sonya Branco, Vice-President

So, the contract is a 10-year full outsourcing with exclusive to CAE with easyJet. We are already serving easyJet by essentially would it, serves about a 40% increase in growth.

Operator

Our next question is coming from the line of Ronald Epstein with Bank of America Merrill Lynch. Please proceed with your question.

Kristine Liwag, Bank of America

And as OEMs walk away from these businesses, can you discuss how that's affected the pricing environment?

Marc Parent, President & Ceo

Well, I don't think that's a factor in the pricing environment to be very frank. I mean there all of these businesses are still very competitive. So, the margins that we would have is the one that we've talked about it in our outlook, and I don't think these particular deals in itself would affect the one way or another the margin expectations that we would have.

Kristine Liwag, Bank of America

And shifting, I guess, to margins. It's a good segway. Can you discuss what you saw in margins in the quarter? I mean there was just a little bit weaker than we expected? And then also with such strong growth and your strong book-to-bill, how does these orders are comparing with your existing business today? Should we expect these orders to be accretive to margins as they convert to revenue?

Marc Parent, President & Ceo

Well, I think the latter definitely the order should be accretive to revenue to for sure. In terms of the margin profile, I wouldn't read too much about margins in the quarter as we were frank off to get that, Q2 is always -- particularly at Civil, always the quarter where we have low actual numbers and lower margins. And because a couple of factors, number one, airlines, if you take training part of our business, airlines are flying a lot in the customers. So, you would expect that if there are opportunities out there and they fit our criteria for the type of the business, the type of assets and of course the financial liability of that, we will be open to it.

I can't talk for any OEMs particularly or anybody else, who have their business, but certainly we seem to form partnerships with those OEMs. And if an acquisition works out, we will certainly be receptive. Under the provides what I said that has to make sense so for us financially for how we can serve our customers and grow our business along the lines to achieve the vision that we have.
summer months. And when they train the aircraft to full
and literally, they’re not training, they are flying.

So, our utilization typically in our training center is low
and you see that. At the same time in our products
business, that is the time where we usually have and
again this year, we have a summer shut down of our
activities and where people take vacation, we are trying
to refurbish the plan, so we basically our activity earning
the revenue and profit out of our full price simulator
business back with us as well. And in this quarter, you
had the additional effect of we have a five week work
stop which has result of the strike in our mainly facility in
Montreal.

So you throw all that in and you see the margins that you
have, but I'll point to the fact that the absolute number
take Civils up to the 19% overall in earnings in this
quarter, I think that we're quite happy with the number
itself. If you look at in Defense, I think you have to
consider maybe less, maybe Sonya have an additional
color. But then you had answer when you take into
account that we acquired AOCE or some couple of
million of acquisition costs in there that are in the quarter,
but -- and Sonya do you want to add any thoughts?

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Sonya Branco, Vice-President

I guess just to compliment that. Overall, I wouldn't read
anything too meaningful into the margin, strong year-
over-year growth on the operating income and holding on
the outlook for each of the segments. But just to
complement what Marc was saying on the Defense side,
you did see a bit of impact of the integration cost. And
also as AOCE acquisition kind of ramps up, although it's
positive and contributed in the quarter that has a bit of
margin dilution in the quarter.

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Marc Parent, President & Ceo

And just to finish up maybe, none of this is highly
unexpected and it was kind of factored in when we came
up with, we traded our outlook this quarter and again we
basically numbers we give you, which reiterating our full
year outlook for all the businesses.

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Cameron Doerksen, National Bank

Sonya, I just wondered if you could maybe just sort of
walk through, I guess, particularly in Civil, how the
quarters kind of looked. You mentioned, obviously, it's
going to be a back-end loaded year, but if I could get
some color around sort of, individually, Q3 and into Q4.
So maybe just if you could just sort of reiterate what you
said there, what we sort of should expect in Q3 and Q4?
It sort of sounded to me like we'd have a much stronger
Q4, maybe Q3, kind of more typical from what you did
last year?

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Sonya Branco, Vice-President

Yes so, we have invested and as I mentioned in my
remarks in Q2 and Q3 to create additional parallel
assembly line, and this will increase our production
capacity to make up for the work stoppage. So, we do
expect to increase the delivery milestones in the second
half, a bit in Q3, but that one as I mentioned should look
a bit like Q1 and Q2, and the majority of the remaining
deliveries probably in Q4. So I would expect there to be
more deliveries in Q4, and when comparing to previous
year, you will note on the IFRS adjusted profile that Q3
was actually the strongest quarter last year because it
had a peak deliveries. So, we expect that to be a little bit
different this quarter and the peak deliveries in Q4.

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Cameron Doerksen, National Bank

And just on the full-flight simulator market, I mean, like
you said, you are on pace to have basically a record year
for new orders for full-flight simulators. Can you just talk
about what you're seeing out there as far as kind of
market share? Is this something where you think you've
gained some share against some of the other
manufacturing OEMs for full-flight simulators? Or is it just
that the pie is much bigger this year versus last year or
previous years?

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Marc Parent, President & Ceo

I think it's a pie really, but we are still maintaining our
leadership in market share. Market share, I think 70%
that's probably above right. And so -- and don't know if
you heard but just to me, it's size of a pie, lots of activity
this year.
Our next question is coming from the line of Tim James with TD Securities. Please proceed with your question.

Tim James, TD Securities

Looking at to fiscal '20, I was wondering if you can talk about any potential headwinds that there might be to margin expansion in both, the civil segment and the defense segment whether its contract mix competitive changes anything like that? I'm making sure I'm sort taking into account or thinking about anything that might moderate any margin expansion that we could see next year.

Marc Parent, President & Ceo

Well, we haven’t given any guidance that far out so, and I'm not going to give it from here right now Tim, but based on the backlog that we have and the dynamics that we see in our markets and all the segments that to me what we see is strong tailwinds everywhere. So, I'm not expecting something on toward. I mean I can't predict the future and future admittedly is not that far away, but based on the future I see is good.

Tim James, TD Securities

That's helpful, that's kind of the way I was thinking about it. I just wanted to make sure I wasn't missing something that might be a bit of a headwind, but that's helpful. Can you tell us approximately what percentage of current Civil revenue comes from business aviation, but before taking to account obviously the future of Bombardier, I that training acquisition?

Marc Parent, President & Ceo

Okay, before the acquisition how much…

Andrew Arnovitz, Vice-President

Tim, its Andrew. We haven't really broken it that way, but training makes up good two thirds of our Civil business and business aviation is probably the 40% of that. So that gives you some sense award of magnitude.

And then my last question just looking to AOCW acquisition, could you tell us how much of the backlog or how much backlog was acquired with that transaction?

Sonya Branco, Vice-President

So, we acquired about CAD500 million worth of backlog. Now, that doesn't flow through any order intake, it's adjusted into the funded and unfunded a backlog, but not necessarily added on as order intake in the book-to-bill metric.

Our next question is coming from the line of Chris Murray with AltaCorp Capital. Please proceed with your question.

Chris Murray, AltaCorp

My first question just going back to Civil and looking at the delivery just I'm trying to understand you had a fairly significant step down in the quarter, and I guess if anything that was little surprised that the revenue actually held better than I thought. I guess the way to think about it or how should we think about the proportion of simulators that are being recognized as like on a completed contract versus still on some sort of percentage of completion. I guess what I'm trying to do is figure with the magnitude of the step jump is going to look like when you get to the back half of the year?

Sonya Branco, Vice-President

So, the revenue growth first of all was driven by not only the product business but the training business, so good growth on both sides. Now, it might be a little bit counterintuitive given the lower deliveries because they are the major drivers of revenue on the product side, and the majority of the simulators are, call it, accounted for at delivery. Now, despite the lower number of deliveries the mix of simulators had an impact, so we had a higher proportion of simulators that included DP&E, which is data products and equipment. And that's where CAE flows through the value of the OEM, data, parts and equipment, so higher revenues but same operating income. And so, that had an impact on the margin as well and the revenue growth. So, those were the major drivers. In addition, they are still some development and customize simulators which are accounted for under...
PUC, but that's the proportion is much less than at delivery.

Chris Murray

And then, just thinking about your production rate, is it fair to think that what's the booking numbers that you are doing? It's really to bring it to a kind of a 1 to 1 book-to-bill? Or is it that you just to try to built some extra backlog just to give you some more flexibility?

Marc Parent, President & Ceo

You mean in term of the -- because of the anticipated higher deliveries in the latter assets that why you're asking the question?

Chris Murray, AltaCorp

Yes, I guess, what I'm trying to think Marc is that you had some pretty strong order intake over the last little while. And if we even look at your trialing, the trailing quarters, you are certainly trialing behind that one-time book-to-bill basically because you don't push it out. Just wondering the changes you've made in the process are intended to speed up your production rates, so we should expect a step up in the next year on actually on deliveries that would be maybe dragging down book-to-bill a little bit, but more on a catch up basis?

Marc Parent, President & Ceo

I'm not sure we are coming from where it was (inaudible) on a settlement that's 20 on the dropping book-to-bill because that's why I don't see that. But our new process that we, with the fully in places, has been for quite a number of quarters now that was started in the year when what we call a quest program a couple of years, which is complete allows us to be able to deliver to manufacture simulators in less time. So, we have increased our production rate right now and in the last half of the year it's going to be much higher because we are recovering from the strike and we have the summer. So, we are accelerating deliveries, we have actually a parallel line on simulators running for a high volume simulators or separate facility producing simulators.

That's why we think we can catch up, but we expect it will catch up in the second half because we want to make sure, we don't disappoint our customers that's expecting simulators. So, look, we will match our delivery rate to the numbers of orders we can expect in the market. We are not production limited. We can get the personnel that we need. So, we are not capacity limited in terms of what we can do. And maybe when I look at -- if you look at the number of sales we had the -- don't forget the day or don't all deliver in the next year, some maybe delivering over two three years for example. So, I don't know if that helps, but that's what I would say to that question.

Chris Murray, AltaCorp

Just two quick questions around the transaction with Bombardier. First of all with the increased training mix and just some geographic changes, any thoughts about how this changes your tax profile?

Sonya Branco, Vice-President

Well, the business jet training is a high margin and high cash generating. So, as we have guided, we expect our earnings accretion in the first year and also free cash flow accretion. So, it should contribute to the highest cash generating of the Company.

Chris Murray, AltaCorp

Yes, I'm thinking about, does it change your tax rates or anything like that with the source of income in the U.S. or anything like that?

Sonya Branco, Vice-President

The majority of the operations I hear in North America, so we will increase our exposure in North America, but one of the benefits of this acquisition is really expanding through the new platforms and a halo effect across our global network. So, I believe it will change the mix throughout the world. So, right now, it doesn't really change my view on tax, but as we close if it changes materially, we will guide.

Chris Murray, AltaCorp

And then, the last question for me just on the royalty agreement. I'm assuming because you are taking a discount on, I would assume to be kind of recurring payments and just lump sum it and depreciated over the life of the agreement. What kind of margin impact should we be thinking about in terms of the Civil margin over the -- once you have got that in place?
Sonya Branco, Vice-President

So, you're right, this was basically future cash flows that we have discounted back and prepaid in exchange for APP agreement up till 2038, at an attractive discount rate about our cost to capital. What we will see is of course I guess capitalization and we will call it depreciation overtime in the P&L. Now, the impact of this transaction has been included in our guidance which is the high digits, single digits earnings in the first year in the first 12 months after closing.

Chris Murray, AltaCorp

Okay, so the guidance included the royalty impact as well as the training impact?

Sonya Branco, Vice-President

Absolutely.

Marc Parent, President & Ceo

Operator, I think that we now want to use the time remaining to open the lines to members of the media. I want to thank all the participants from the investment community for their questions. Operator, if you will please open the lines to members of the media.

Operator

Thank you. Ladies and gentlemen as a reminder, to register for a question please press the 1 followed by the 4. One moment please. There are no questions from the media at this time.

Marc Parent, President & Ceo

Okay, well, I want to take this opportunity once again to thank all participants on the call today and to remind you that transcript of the call can be found on CAE's website. Thank you very much.

Operator

Ladies and gentlemen, that does conclude the conference for today. We thank you for your participation, and ask that you please disconnect your lines.