Question and Answer Session

Operator

Our first question comes from Benoit Poirier of Desjardins Capital Markets. Please go ahead.

Benoit Poirier, Desjardins Capital Markets

Good afternoon. First question is on the IFRS 16. Could you maybe quantify, Sonya, what should we expect in terms of amount of depreciation and finance expense that will be added from the IFRS 16 this year and how does the IFRS 16 impact your guidance in terms of operating income?

Sonya Branco, Chief Financial Officer

So first, all of the IFRS 16 has been reflected on the operating income guidance. So the main impact of the new standard is to bring all the leases on balance sheet and the lease liabilities. So, on the asset side we see about $230 million of additional right-of-use assets and about $260 million on lease liabilities.

On the P&L, it’s really a question of nature and timing of expenses that’s impacted. With the rent expense being replaced by amortization and financing expense, it can, honestly, nothing changes, just on timing and classification. And the interest guidance that I just mentioned of a new run rate of about $30 million a quarter reflects the impact of the new debt that we just issued and also the impact of IFRS 16. Now there is some timing leakage that happens and so, hence, we see an EPS headwind of about $0.01 for us by 2020.

Benoit Poirier, Desjardins Capital Markets

Okay, perfect. That’s great colour. And looking at healthcare, Marc, could you maybe provide more colour about the strategy under the new president in terms of greater scale and also return on investment? I would be curious when you talk about double-digit target, whether it’s in terms of revenue or operating income. Thanks.

Marc Parent, President & Chief Executive Officer

Well, I think double digit would apply to top and bottom line, Benoit. I think the strategy is just basically seizing on a momentum that we have and taking us to the next level. And Rekha Ranganathan, our new leader, has a very strong track record of doing that. She was head of
Philips Healthcare, one of the major divisions, has a strong network in the healthcare sector, and brings a level of expertise and knowledge at the top management level in healthcare that I think we need as we go to the next level. The products we develop to attack the new sectors that we targeted the last couple of years, in nursing specifically, are paying off. The momentum is good. And it's really now a question of obviously selling more. I think if we look at the past year, fourth quarter was very good. It took us a while to ramp up the sales force, and that's been the drag that you see on the bottom line mainly, plus the development cost themselves, but those additional sales force and products are starting to pay off. And I think that the purchase we made (inaudible), all of that is going to lead to, is factored into the guidance I have. And I think the strategy, if we make any changes, you know, basically we'll report that as we let Rekha get on her feet and take a look at the market and see if we might make any changes, but I think right now is steady as she goes.

Benoit Poirier, Desjardins Capital Markets

Okay. And last question, if we look at the civil business, Marc, could you talk a little bit about the training requirement that could come from the 737 MAX and also whether the softness we see in some traffic numbers in Asia, whether it's impacting your civil business? Thank you.

Marc Parent, President & Chief Executive Officer

Well, you know what? On MAX, you would understand that, you know, I'm not going to say much on that. It's CAE's policy, in any event like this, no matter what it is, never to comment on a situation itself, for obvious reasons. There are investigations underway. But suffice to say that for us that you assume that as a world leader in aviation training, we're going to have a role to play in maintaining the safety and efficiency of the air transportation system as a major player. So for us, we've got the capability, we've got capacity to support whatever transpires to get the airplanes back into the air, to support them, support the airline customers, OEMs, the regulators, to ensure the training needs are met. That's all I'll say about that.

And the last end of your questions in regards to.... Can you repeat the question with regards to Asia?

Benoit Poirier, Desjardins Capital Markets

Oh, just related to some softness that came from the traffic numbers in Asia. I was just curious, given your involvement in Asia, your exposure, whether you see an impact on your training business.

Marc Parent, President & Chief Executive Officer

No, not really. I think demand for training is strong across the board. I mean we see some, you know, events, to a certain thing you always see like some airlines going out of business, but what we see is the demand being picked up pretty much immediately by other carriers. And, at the same time, we continue to win share. You saw the contracts we signed this year, the ones I mentioned, like Avianca, easyJet, Asiana, just to cite those three. So overall, basically things, in terms of passenger traffic for us as it relates to training, is still going up.

Benoit Poirier, Desjardins Capital Markets

Okay. Thank you very much. For the time.

Operator

Thank you. Our next question comes from Ronald Epstein of Bank of America Merrill Lynch. Please go ahead.

Kristine Liwag, Bank of America Merrill Lynch

Hey, guys. It's Kristine Liwag calling in for Ron. Following up on your commentary on the 737 MAX, I was wondering, can the Boeing 737 NG simulators be converted to a 737 MAX simulator? And if it can, what does that entail?

Marc Parent, President & Chief Executive Officer

Well, look, I think, again, Kristine, I'm going to go back and I'm not going to comment much about anything really related to the MAX simulator because of the situation that's unfolding.

But your short answer, it's pretty much any one of our simulators, no matter what type, can be converted to another (inaudible). And we kind of do that all the time. We even take simulators from other manufacturers and convert them to quasi-CAE simulators, and that's part of our aftermarket business that we do. So short answer is, yeah, it's possible, just any type it's possible to do that.
Kristine Liwag, Bank of America Merrill Lynch

I see. And you mentioned that, you know, should there be more training required to get the aircraft back into service, you have the capability to meet this demand. Can you talk about what that means in terms of your capability? Does that mean you can build more full-flight simulators if needed or increase you utilization? Can you talk about, to the extent that you can, if there is more demand, how could you meet it? Do you need to build more and add more capacity? Can you discuss that?

Marc Parent, President & Chief Executive Officer

Well, I think we’ve demonstrated again this year, if you look at how we were able to recover in the past year, remember, during our last fiscal year that we just reported on we had a five-week work stoppage because of a strike in our manufacturing facility in Montreal. So we lost five weeks’ worth of production and we were still able to completely ramp up and stand up separate production lines and basically recover all of the deliveries that we had and then some, which demonstrates our capability to flex. And we don’t have to add, you know, we have significant capability left in our factories. We’re not on three shifts. We’re about 1.5 shifts. And we could ramp up to meet any demand, well, any is a big word, but I think that substantial capacity on any aircraft type. And we demonstrated, ah, we’ve got a million square of manufacturing capability in Montreal and we always find a way to able to optimize what we do. So long answer but, yes, we can scale up.

Kristine Liwag, Bank of America Merrill Lynch

And then lastly, if I could, with your strong book to bill of civil orders, I think it’s 1.48 times, can you parse out how much of that is from hardware versus service?

Marc Parent, President & Chief Executive Officer

I don’t have the number offhand. I don’t know, Sonya, if have it offhand? But it’s a mix of both.

Sonya Branco, Chief Financial Officer

It’s a mix of both. We don’t necessarily have or disclose the split but suffice it to say that it was a great year for products but also on the services side and both grew very strongly.

Kristine Liwag, Bank of America Merrill Lynch

Thank you very much.

Operator

Thank you. Our next question comes from Turan Quettawala of Scotiabank. Please go ahead.

Turan Quettawala, Scotiabank

Yes, hi. Good afternoon. Thank you for taking my question. I guess firstly on the civil side, Marc, I’m wondering if you could just comment a little bit about the order flow. I mean you obviously had a few pretty strong years of order flow on the FFS side with certainly 78 orders this year. When you talk to your sales channels, like do think there’s a few more years of this type of order flow or do you think we’ve kind of reached a peak here?

Marc Parent, President & Chief Executive Officer

Look, we had a high number, more than we even anticipated. Often, as you can well imagine, at the end of the year, I mean all it takes is a couple of weeks for something to fall out of the year and into year and we don’t work that way. We sign them when they’re ready to be signed. So, look, I think the manufacturer’s production lines are at very high rates, they have very high backlog, and the delivery of full-flight simulators or orders for full-flight simulators is very highly correlated to the delivery of aircraft at the manufacturer, which is mainly Boeing and Airbus. I mean that’s really what dictates the demand for simulators.

Now, if I think of training as a whole, there’s a lot of headroom in training. You know, civil aviation will double over the next 10 years for sure, so that’s a lot of training demand coming our way, including simulators.

Turan Quettawala, Scotiabank

Thank you. And I guess just one more from me on the margins in D&S. There was a lot of volatility in margins last year, I guess in fiscal 2019. Just can you talk a little bit about whether we should expect a bit more of a volatile year in 2020 as well? And then also, do you expect margin expansion in D&S in 2020?
Marc Parent, President & Chief Executive Officer

Well, I think I’ll let Sonya maybe comment in more detail, but I think I’ve always been pretty consistent in saying you never should look at order intake or margins or even possibly revenue for defense on a quarterly basis, because it’s largely a contract business. So, depending on which contracts you execute during the quarter, you can have pretty interesting swings, as we’ve seen in the past. And when you sign contracts, it can vary. So it’s best to look at these on a 12-month basis.

So maybe, Sonya, you want to comment?

Sonya Branco, Chief Financial Officer

No, I agree. We shouldn’t look at it on a quarterly basis, because the variability is really a reflection of the defense business. And, as we’ve seen in the past quarter, the mix of products and services and the progressions of the programs and when they hit their milestones has a significant impact. Overall, the backlog as a whole, we continue to see it at 11% to 12%, but it will vary as it flows through the income and as we execute. So that’s why we remain focused on the annual outlook and operating income growth as a whole and our outlook for the next year is mid- to high-single digit percentage growth for 2020.

Turan Quettawala, Scotiabank

And the backlog you said, Sonya, was it 11% to 12%?

Sonya Branco, Chief Financial Officer

That’s right.

Turan Quettawala, Scotiabank

Thank you very much.

Operator

Thank you. As a reminder, you may press the one followed by the four to register a question or comment.

Our next question comes from Mayooran Mahadevan of BMO Capital Markets. Please go ahead.

Mayooran Mahadevan, BMO Capital Markets

Hi. Just on for Fadi Chamoun. My first question is on your fiscal 2020 guidance. Typically, pace of the earnings are usually second half weighed. How do you see that playing out for fiscal 2020? And can you also confirm if the guidance is based on the numbers excluding special items?

Marc Parent, President & Chief Executive Officer

Excluding what, sorry?

Mayooran Mahadevan, BMO Capital Markets

The special items.

Marc Parent, President & Chief Executive Officer

The special items. Okay. Sorry. Got it. Well, I think it’s reasonable to expect, based on what we see on order flow on the deliveries of simulators, it will be way towards a back half for sure.

Sonya, do you want to expand on...?

Sonya Branco, Chief Financial Officer

Yeah, no. So, the way that we see deliveries and kind of the order backlog flowing through, it will be, like other years, kind of H2 heavier. And in terms of the outlook, it’s on the number before specific items, so adjusted for specific items.

Mayooran Mahadevan, BMO Capital Markets

And then my second question, just on, you know, you have a great training franchise with a dominant market position, but your capital intensity, it remains kind of high. Are there levers that you guys can utilize to improve asset returns and improve your cash flow and ROIC?

Sonya Branco, Chief Financial Officer

So we’ve spent about $250 million in CapEx this year and we do see a bit of an increase next year, but really this is a reflection of the good momentum that we see in the market. And we continue to see really good opportunities to serve market demand, continued outsourcing, and to the extent we see this, these opportunities, we’ll continue
to invest in accretive growth, accretive to earnings and accretive to return on capital. And as we’ve seen, all the new capital that we’ve deployed, it goes to work very quickly and within, call it, about 24 months it generates 20%, 30% accretive incremental return and cash flow.

So really this is a reflection of the market demand that we see out there. And should there be any change, well then we would revise our investment accordingly and really look to our capital allocation strategy and balance the investments between investments in growth, cash returned to the shareholders, and a solid balance sheet. And our first priority remains investing in growth.

Marc Parent, President & Chief Executive Officer

Look, again, as I was saying to analysts, I’m not going to comment much about the specific MAX situation itself, but what I can tell you that’s factual is that we’ve sold 43 Boeing 737 MAX simulators to date, which is highest proportion of the one of, because of our market share, of the simulators that have been sold. We delivered 10 so far. I don’t want to comment about the changes in the dynamics and, to be frank, that dynamic will continue to be paced by the delivery of aircraft, you know, unless there was dramatic change in how training is done. But I’m not going to comment or opine on that one way or another because it’s still in the hands of regulators.

Allison Lampert, Reuters

And what about the cost? How much does it roughly cost to make such a conversion?

Marc Parent, President & Chief Executive Officer

Convert from what to what? I’m sorry?

Allison Lampert, Reuters

Convert, you said it’s possible to convert, for example, an NG simulator to a MAX simulator.

Marc Parent, President & Chief Executive Officer

That, again, I’m not going to (inaudible) that, because you would have to assume that what is the change that you’re trying to make. So I can’t really comment because the scope of what you’re can be very, very, ah, you can go from a small change to a massive change that reflects everything in the aircraft, which you don’t necessarily have to do to absolutely represent a 737 MAX.

So I can’t answer your question with any precision and, frankly, I really, again, going back to what I said, don’t to comment because it’s our policy never to comment on specific situations involving accidents.

Operator

Thank you. Our next question comes from Sylvain Larocque, Quebecor. Please go ahead.
Operator

As a reminder, for the media to register any questions, you may press the one four.

Sonya Branco, Chief Financial Officer

Our next question comes from Michael Bruno of Aviation Week. Please go ahead.

Michael Bruno, Aviation Week

Hi. Thanks for taking my question. I’m curious as to how much interest do you see from the OEMs like Boeing or Airbus to get into your business of pilot training. Certainly, Boeing is going into more vertical integration in some of its business portfolio and I’m of curious if you feel any kind of concern or do you see a threat out there from the OEMs trying to do more of what you do.

Marc Parent, President & Chief Executive Officer

Well, I think that all OEMs have got a service strategy and Boeing is not the only one out there. What I would tell you is that a lot of companies, actually most companies in the aerospace industry, you know, sometimes we partner, particularly on the defense business. For example with Boeing, we’re the exclusive provider of Boeing P-8A simulators for Boeing and we’re very proud of that and I think we have a very great working relationship. We cooperate in a number of sectors but, yeah, they have a strategy to grow in aftermarket services. As I said, all OEMs do.

For us, I’ll be very frank with you, we focus on our end customers, and those are the airlines with business aircraft operators, and we do what we can to satisfy the needs of our end customers and I think we’ve grown a very successful franchise as the largest training company in the world and, you know, you would expect us to be able to do that because CAE is really a pure-play training company and it’s the largest in the world in what we do. Largest in selling simulators, largest in terms of deployed network, and largest airline training company in the world. So, for us, we stay focused on our game. And it’s a large market, so I think what you see is OEMs, in a large case,
providing the initial training support for their customers as they deliver aircraft and I would expect them to continue to do that. But I can’t answer for them. But we play our own game and we focus on innovation and being the innovation leader to provide the highest level of, you know, basically advancement of the science of learning as applied to airline pilot training, and that’s what we do.

Operator

Thank you. We show no further questions. I’ll turn the call back over to our host.

Andrew Arnovitz, Vice President, Strategy & Investor Relations

Operator, thanks very much for hosting our call today and I want to thank all participants, members of the financial community, and media for joining us this afternoon. And I’ll remind you that a transcript of today’s call can be found on CAE’s website. Thank you.

Operator

That does conclude the conference call for today. We thank you for your participation and ask you to please disconnect your line. Thank you and have a good day.

Operator

This concludes today’s conference call. You may now disconnect.