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Desjardins Capital Markets

Cameron Doerksen
National Bank Financial

Kevin Chiang
CIBC

Tim James
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QUESTION AND ANSWER SESSION

Operator

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

Benoit Poirier, Desjardins Capital Markets

Good afternoon, everyone. Could you talk a little bit about defence, your confidence to reach your guidance for the full year? I mean when we look so far in terms of EBIT margin, you've been averaging 9%, so in order to do meet the guidance it must imply that you should be closer to 15% in Q4, so if you could provide more details about what makes this guidance achievable. Thank you.

Marc Parent, President & Chief Executive Officer

Thanks, Benoit. It's Marc. Look, I think we understand the ramp up for Q4, we certainly couldn't be confident in giving the outlook or reiterating outlook that we have. I mean the confidence that we have is really based on the fact that we understand well the factors that leads to performance in Q3 as a whole, the year as a whole I mean, and the ones that we described in the call, specifically in Q3, the ramp up of our service contracts, AOCE, the U.S. Navy, CNATRA, that are generating a lot of revenue, and you see that revenue growth, which is quite impressive, but they're not carrying a lot of profit at this time, because they're just ramping up, they've got integration costs associated with them, and they'll ramp up over time, over the next few quarters. At the same time we have some impacts in the two programs that generate higher margins, product-intensive programs like the Canadian Fixed-Wing Search and Rescue programs, building simulators for C295 aircraft for example, and some contracts, naval contracts specifically in UAE.

So we understand the factors that lead, you know, where those programs are. We've already re-baselined those programs. We've got agreements with the customers. I personally have been involved in some of those. So, we have pretty good confidence in the programs that we have to execute from backlog in the quarter as what we will be able to get in the quarter as top and bottom line contribution from those programs. So, that we understand pretty well.

At the same time, we have programs that we've already been selected for, so orders that we don't necessarily have right now but we've been selected by the customers, and we fully expect and have, in most cases, agreements with a customers to get those done by the time that we reach the end of quarter. And because we got work in progress in some of those programs, those will trigger revenue and profit as soon as we sign them. So that's really the basis of the confidence in the outlook that we've given to be reaching the outlook in a quarter, on defence specifically, and for the year as a whole.

Benoit Poirier, Desjardins Capital Markets

Okay, perfect. And I know it's early, but fiscal 2020, obviously you're still ramping up a few projects. Could you talk a little bit about what is implied in terms of your defence margins and your backlog? Is it closer 11%, 12% or closer to the low end? And is there a lot of ramp-up expected also in fiscal 2020 that could probably put some pressure?

Marc Parent, President & Chief Executive Officer

The backlog that we have is in the 11%, 12% range. So that hasn't changed. The mix will get, you know, it will depend a lot on the service versus product mix that we get. That will be affected by the orders we win. So it's a bit early to provide you with the outlook for the year. We typically do that next quarter and we'll do that again.

I mean, suffice to say, it's a growth business and continues to be a growth business. We fully expect at $4.6 billion of proposals that we have there to contribute nicely to the growth, but it's too early for me to tell you. But, as I said, the backlog at the moment supports the 11%, 12% range. I think we'll be more focused in the whole of our business, as you've seen us be in the last couple of years, certainly this year, on focusing on absolute dollar growth, SOI growth in dollars, because that more accurately reflects the mix of our business products versus services. And from a geographical point as well. And in the end, you know, it will support the ROC growth, the return on capital growth expectations that we have that Sonya talked about for business as a whole, you know, 13% by our fiscal 2022.

Benoit Poirier, Desjardins Capital Markets

Okay. And just for healthcare, could you talk a little bit about what we should expect in Q4 and going forward? I understand that there has been a lot of investment but just wondering if you're going to reap some benefits in Q4 and toward fiscal 2020.

Marc Parent, President & Chief Executive Officer

Yes, we certainly anticipate that, as we said in our outlook. I think, you know, I'm confident. And in terms—one thing that's probably worth noting is the investment that we make in healthcare, interestingly, the cash flow we generate, the business supports itself. I think you want to expand on that, Sonya.

Sonya Branco, Chief Financial Officer

Healthcare is cash flow positive and essentially self-sustaining. So it's using its own cash flow to reinvest in both R&D and sales expansion and we see that with our delivery of three new lines of manikins, whether it's Juno, Ares, and now with Luna, to really kind of focus on that mid fidelity market and nursing market, which is the largest pool of value. So, continue to see good growth prospects and this investment on the sales expansion and the new product launches will yield higher volume.

Benoit Poirier, Desjardins Capital Markets

Okay, perfect. Thank you very much for the time. I'll get back in the queue.

Marc Parent, President & Chief Executive Officer

I'll just add to that, Benoit, that one thing that hasn't changed is like the profitability of the products that we have in healthcare is quite healthy, so any increase in revenue would result nicely in accretion to the bottom line.

Benoit Poirier, Desjardins Capital Markets

Okay. Thank you.

Operator

Thank you. Our next question comes from Cameron Doerksen of National Bank Financial. Please go ahead.

Cameron Doerksen, National Bank Financial

Thanks. Good afternoon. Just a couple questions for me. I guess maybe firstly on the, you know, you mentioned that you'd bought out your JV partner, Avianca, the JV there. I'm just wondering, I guess it's sort of the second one we've seen of these in recent years, I'm just wondering if there are any other opportunities or do you expect to maybe ultimately buy out a number of other JV partners that you have on the training side?

Marc Parent, President & Chief Executive Officer

Well, I think it will be a combination of things. I can't really comment about the JVs that we have. Those would be confidential in nature if we had some. But I think, look, I think there's a trend out there, and I've talked about it before, that there's more of a trend towards outsourcing training, because, if anything, we've created a very strong alternative for airlines to do that. So, the pipeline of deals that I see is much stronger than previous years. Going back couple of years, I would always say that you like to see one or two of these a year. Certainly we've done better than that this year. And I would expect that to continue. Pipeline is good. And that could contribute to being deals like we buyout the remaining portion of the JV, but notwithstanding, that doesn't have to be the case. We certainly have other airlines that either are starting up or have present installations that they might want to partner with us. So, it's going come in either one of those fashions, but I think we're going to continue to see a higher level of activity from that point of view.

Sonya Branco, Chief Financial Officer

And if I could just add, as Marc said, we continue to see an active pipeline of conversations on outsourcings, and the way that they culminate can take different forms. So now we've seen a couple of JV buyouts with Avianca and AirAsia last year, creation of new JVs with Singapore Airlines, but also these things also culminate in long-term training agreements with organic CapEx or existing CapEx deployment like easyJet. So, ultimately, the momentum, I think, is stronger on these outsourcings, but they take many forms. Whether it's JVs, M&A, or organic deployments, we're looking for the outsourcings, and it's essentially driving increased outsourcings for training to CAE.

Cameron Doerksen, National Bank Financial

Okay, great. And just second question, you know, I guess the Bombardier business acquisition is going to close here in the quarter. I'm just wondering—I know it's probably going be pretty seamless but I just wonder if there's any integration costs that we should expect in the quarter or early part of 2020. I would assume if there are they're probably pretty low.

Sonya Branco, Chief Financial Officer

We should see some integration, restructuring, and transaction costs. So, while we believe that the execution risk is low, there is some overlap on certain roles and cost to integrate the transaction. So, I would expect to see some integration costs in the quarter. We had indicated at the time that we saw a level of synergies of about US$6 million. The integration costs should be a little bit in line or a bit higher than that. And we expect, depending on the timing, it should align with a shortly after the closing.

Cameron Doerksen, National Bank Financial

Okay. That's great. Thanks very much.

Marc Parent, President & Chief Executive Officer

Thanks, Cameron.

Operator

Thank you. Ladies and gentlemen, as a reminder, you may press the one followed by the four on your telephone keypad if you would like to register a question or comment. One moment please.

Our next question comes from Kevin Chiang of CIBC. Please go ahead.

Kevin Chiang, CIBC

Hi. Thanks for taking my question here. Maybe just a follow-up on Benoit's question earlier around defence margins. I'm just wondering, as you become more or as you focus more on this training system integration strategy, does that inherently create more, let's say, quarterly volatility in your margin profile given the ramp up and some of the upfront costs you have to incur as you build up these programs? Is this margin volatility maybe a consequence of that or is this your, fiscal 2019 that is, is this year just maybe a little bit more unique than a typical year?

Marc Parent, President & Chief Executive Officer

I think if you were to look back, you know, I've been in this business for quite a few years now and I actually used to run defence before I became CEO, and I think if you look back you'll find pretty significant quarterly variation. And that, to me, it should be expected, specifically of the defence business, because in one quarter we're going to execute, like we're doing in this quarter for example, some programs that will drive different levels of profitability depending on which execution you do on those contracts in the quarter. Remember, we use percentage of completion accounting, which means that we're booking profit at the same time as we're incurring cost, so depending on the level of activity you have on that specific program in the quarter will dictate a number. And, of course, if you execute another program in the following quarter that's a different profitability profile, it'll leave a different answer. The service contracts will give you, because they're longer term, they will provide to me, if anything, a more stable base, both in terms of revenue you expect during those quarters and through profit, except when you're ramping up like we're doing on the ones that we talked about, integration of AOCE and the U.S. Navy CNATRA program.

So, I guess the long answer would tell you, I think it's very hard to judge the performance on a quarterly basis, and that's why our outlook is yearly. And I think we're going to continue that way. And I really think that's where you should look at it. And when we provide order intake, again, I think the best judge of the growth of the business is to look at leading indicators like that's the pipeline and, more specifically on the book to bill, judge on a 12-month basis, again, to eliminate these quarterly variations.

Kevin Chiang, CIBC

That's super helpful here. And maybe just a point of clarification. You talked about repositioning within healthcare or a bit of a market repositioning here. Does that change how you think about the total size of the available revenue to you when this business matures?

And then, secondarily, in the near-term here as you go through this pivot, does that, at least in the near term, change maybe how we think about operating leverage? Are there additional costs that we should be thinking about that might be incurred even as revenue starts to ramp up here as you execute against this strategy?

Marc Parent, President & Chief Executive Officer

I think the first part of your question, I would say the answer is no. Look, I still am confident in the growth profile of this business, in the absolute size that we get to over the longer but not too long period. So that hasn't changed that that (inaudible). Remember what we said last year when we embarked on repositioning our businesses, we stopped waiting for really regulation to really come in force and really be the driving force behind this business and refocus our efforts, our product development and our focus on the market that's there today. And the market that's there today is largely, in aggregate, nursing programs. There are 2,000 of those programs in the United States alone. So that's where we're focused. And if I look at the size of that market, it by itself can support our ambitions of the size of the business. So that hasn't changed.

In terms of the costs, I think what you're seeing as increased now affecting the leverage is mainly SG&A, mainly sales force to go after repositioning. You have a large number of schools out there, institutions, hospitals, so we're increasing the sales force. So, we are going to continue to do that but, as I said a bit previously in my answer to Benoit Poirier, is that the margin profile of the products that we sell in healthcare, I think if we start getting some decent revenue growth, it'll disproportionally drop to the bottom line.

Kevin Chiang, CIBC

That's super helpful. Thank you very much.

Operator

Thank you. Ladies and gentlemen, as a reminder, you may press the one followed by the four on your telephone keypad if you'd like to register a question or comment. At this time, we'd like to welcome press and media to join the queue.

Andrew Arnovitz, Vice President, Strategy & Investor Relations

Operator, thank you. We will open the lines now to members of the media and I thank members of the financial community for their questions.

Operator

Thank you. We do have one final question from an analyst that comes from Tim James of TD Securities. Please go ahead.

Tim James, TD Securities

Thank you. I'll just jump in here quickly. Question I think for Sonya. I'm just taking a look and I'm trying to understand the large, I guess it was about $380 million increase in the combined assets of PP&E and the intangible assets in the quarter relative to the second quarter. I know $200 million of that is from the Bombardier royalty monetization and it looks to me like another kind of net $35 million increase from CapEx, but then there's another kind of $150 million I'm trying to wrap my head around in terms of where that increase in those assets came from. Could you help me understand that?

Sonya Branco, Chief Financial Officer

Absolutely. So, you're right, the main driver was the increase coming from us closing the monetization, which was $202 million of capital. Of course, we've added CapEx in the quarter, but the missing piece in the reconciliation is foreign exchange.

The rate closed quite high at 1.36 USD to Canada at the end of the quarter and that drove essentially all of the U.S. operations, et cetera, in closing assets like goodwill and tangible fixed assets, at a much higher rate, and so that's the 100 sum odd plus that that drove that increase.

Tim James, TD Securities

Okay. That's helpful. I didn't realize the FX was that significant. Thank you, Sonya.

Andrew Arnovitz, Vice President, Strategy & Investor Relations

Okay. Operator, if you would please open the line to members of the media.

Operator

My pleasure. Ladies and gentlemen, via the phone lines, you may press the one followed by the four on your telephone keypad to register a question or comment.

And we show no questions from the press or media. I'll turn the call back over to you for any closing remarks.

Andrew Arnovitz, Vice President, Strategy & Investor Relations

Okay. Well, thank you. I want to thank all of the participants this afternoon for joining us on our call and remind you that a transcript of the call can be found on the CAE's website. Thank you.

Operator

Ladies and gentlemen, that 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.
