CAE

REMARKS FOR CAE'S SECOND QUARTER FISCAL YEAR 2020

November 13, 2019

Time: 1:00 p.m.

Speakers:

Mr. Marc Parent, President and Chief Executive Officer

Ms. Sonya Branco, Vice President, Finance, and Chief Financial Officer

Mr. Andrew Arnovitz, Vice President, Strategy and Investor Relations

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Good afternoon, everyone, and thank you for joining us today.

Before we begin I’d like to remind you that today’s remarks, including management’s outlook for FY20 and answers to questions, contain forward-looking statements. These forward-looking statements represent our expectations as of today, November 13, 2019 and accordingly are subject to change. Such statements are based on assumptions that may not materialize and are subject to risks and uncertainties. Actual results may differ materially, and listeners are cautioned not to place undue reliance on these forward-looking statements. A description of the risks, factors and assumptions that may affect future results is contained in CAE’s Annual MD&A available on our corporate website and in our filings with the Canadian Securities Administrators on SEDAR at www.sedar.com and the U.S. Securities and Exchange commission on EDGAR at www.sec.gov.

On the call with me this afternoon are Marc Parent, CAE’s President and Chief Executive Officer, and Sonya Branco, our Chief Financial Officer.

After remarks from Marc and Sonya, we will take questions from financial analysts and institutional investors. Following the conclusion of that Q&A period we will open the call to questions from members of the media.

Let me now turn the call over to Marc…

Marc Parent, President and Chief Executive Officer

Thank you, Andrew, and good afternoon to everyone joining us on the call. I’ll first discuss some of the highlights of the quarter, and then Sonya will review the detailed financials. I’ll come back at the end to talk about our outlook.

CAE had good growth in the second quarter with revenue up 21 percent, segment operating income up 28 percent, and we secured nearly $1 billion of orders, for a 1.11 times book-to-sales ratio. CAE’s total backlog at the end of the quarter was $9.2 billion.

Our performance continued to be led by Civil, which delivered very strong operating income growth, higher margins, and continued to have strong order intake. The integration of the Bombardier Business Aircraft Training acquisition has gone very well and is substantially complete, and we’re continuing to win the confidence of our airline and business jet customers with our expanded and highly innovative training solutions.

Defence performance improved from last quarter; however, it reflects continued delays for orders of our higher margin defence products, and the timing of program milestones on contracts that we're currently working on from backlog. These are largely timing issues and I'm encouraged by the 1.08 times book-to-sales ratio for the quarter, which gives confidence to our view of a stronger second-half for Defence.

And in Healthcare, our expanded salesforce secured a high level of interest in our latest products, which will begin delivering over the next few quarters.

Looking more closely at **Civil**, we booked $603 million of orders in Q2, including new long-term pilot training agreements with Sunwing Airlines, Loganair and Flightworks. We also sold 11 full-flight simulators during the quarter, for a total of 20 for the first half of the year.

To address the growing global demand for new pilots, we launched a new cadet pilot training program to train more than 700 new professional pilots over the next 10 years for Southwest Airlines Destination 225° program. And just this week, we signed a long-term exclusive training agreement with easyJet to train more than 1,000 new easyJet cadet pilots under a Multi-Crew Pilot License program. Also involving easyJet, we inaugurated new training facilities during the quarter in Gatwick, Manchester and Milan in support of our comprehensive, 10-year training agreement.

In business aviation, we entered a strategic partnership and exclusive 15-year training outsourcing with Directional Aviation Capital and its affiliates. Directional is one of the largest, fastest growing, and most innovative corporate aviation service companies globally. And in connection with this agreement, just last week, we concluded the acquisition of a fifty-percent stake in SIMCOM Holdings.

Overall training centre utilization was 69% this quarter on our network of nearly 300 full-flight simulators. Airlines train a bit less during the busy summer travel months and so we used the opportunity of this usual seasonality to perform some simulator updates and relocations, coincident with the opening of our new training centres during the quarter. The utilization rate also reflects the effect of some of our recently added capacity that’s now just beginning to ramp up.

In **Defence**, we booked orders for $362 million, including KC-135 aircrew training services and simulator upgrades for the U.S. Air Force, and additional fixed-wing flight training and support services for the U.S. Army at the CAE Dothan Training Centre. We also received orders to upgrade the U.S. Navy’s MH-60 Seahawk helicopter simulators and to provide aircrew training on the Navy’s T-44C aircraft. Other notable orders include a contract with Boeing to provide upgrades on P-8A simulators, a contract to upgrade the German Eurofighter and Tornado aircraft simulator, and a contract for Abrams M1A2 tank maintenance trainers for the U.S. Army. As well, to further bolster our position in the United States, we entered a strategic collaboration with Leonardo to offer integrated helicopter training solutions together.

And in **Healthcare**, we continued to pursue larger segments of the healthcare simulation market with our expanded salesforce. In line with our strategy to expand our reach within hospitals, we have entered into an agreement with Premier, a leading healthcare improvement company, aligned with approximately 4,000 U.S. hospitals and health systems. We also launched new products including Vimedix 3.0 ultrasound simulator, and together with the American Society of Anesthesiologists, we launched a new Anesthesia SimSTAT module, which is the latest in a series of interactive screen-based courses approved for Maintenance of Certification in Anesthesiology credits.

With that, I will now turn the call over to Sonya who will provide a detailed look at our financial performance. I'll return at the end of the call to comment on our outlook. Sonya?

Sonya Branco, Vice President, Finance, and Chief Financial Officer

Thank you, Marc, and good afternoon everyone.

Consolidated **revenue** for the second quarter was $896.8 million, up 21% compared to $743.8 million in the second quarter last year, and **segment operating income before specific items** was $126.0 million, up 28% from $98.7 million last year. Quarterly **net income before specific items** was $74.7 million, or 28 cents per share, which is 22% higher than the 23 cents we reported in the second quarter last year.

Net finance expense for the second quarter was $34.3 million, up from $19.9 million in the second quarter of fiscal 2019. We had higher interest resulting from the long-term debt we issued at the end of last year, higher interest on lease liabilities because of the adoption of IFRS 16, as well as a higher investment in non-cash working capital in the first half of the year.

Income taxes this quarter were $15.5 million, representing an effective tax rate of 17%, which is down from 19% for the second quarter last year. The lower tax rate was mainly due to a change in the mix of income from various jurisdictions.

Free cash flow was negative $7.1 million in the quarter compared to positive $137.7 million last year. Cash provided by operating activities increased compared to second quarter last year, while free cash flow decreased, mainly from a higher investment in non-cash working capital accounts. Most of the increase is timing-related as we usually see a higher investment in non-cash working capital accounts in the first half. This increase reflects the timing of cash flows involving accounts payable and contract liabilities. It also reflects higher inventory from recent strategic investments in simulator advanced builds to pre-empt customer demand that we anticipate for certain simulator products. As in previous years, we expect a significant portion of the non-cash working capital investment to reverse in the second half.

Uses of cash in Q2 included funding **capital expenditures** for $58.8 million, mainly for growth and specifically to add capacity to our global training network to deliver on the long-term exclusive training contracts in our backlog. We continue to expect total capital expenditures for the year to be about 10-15% higher than in the prior year. Other uses of cash include the distribution of $28.4 million in cash **dividends,** and we used another $18.2 million to repurchase stock at a weighted average price of $34.06 per common share under the **NCIB** program.

Our financial position continued to be solid with a **net debt** of $2.4 billion at the end of the quarter for a net debt-to-capital ratio of 51.0%. This reflects the issuance of the unsecured senior notes for the Bombardier BAT Business acquisition, and the higher usage of cash to fund working capital in the first half of the year. Since we adopted IFRS 16 effective April 1, 2019, net debt now also includes obligations under lease contracts which were previously accounted for as operating leases and therefore not included in debt. Excluding this impact, the net debt-to-capital ratio would have been 47.5% this quarter. We continue to expect to be at the lower end of our target leverage range—which is 35 to 45 percent on a pre-IFRS basis—within the next 18 to 30 months.

Return on capital employed, before specific items and excluding the impacts of IFRS 16, was 11.7% this quarter, compared to 12.0% last quarter and 12.8% last year. As we ramp up the large Bombardier BAT Business acquisition and our other growth investments, we expect to reach 13% return on capital employed by fiscal year 2022.

Now looking at our segmented performance...

In Civil, we had strong double-digit organic growth in the second quarter, and in addition we benefited from the integration of the Bombardier Business Aircraft Training business, which also performed very well. Second quarter revenue was up 35% year over year to $529.9 million on 18 full-flight simulator deliveries and continued strong demand for our training services with our expanded capacity.

Operating income before specific items was up 60% to $101.4 million, for a margin of 19.1%. On the order front, the Civil book-to-sales ratio for the quarter was 1.14 times and for the trailing 12-month period it was 1.45 times.

In **Defence**, second quarter revenue of $336.5 million was up 5% over Q2 last year, while operating income was down 24% to $26.0 million, for an operating margin of 7.7%. In Defence, product margins are typically higher than services, and while we did see a more balanced mix compared to last quarter, it was still more weighted to services. The lower segment operating income in the second quarter also reflects delays on product orders we expect to conclude this year, as well as timing-related factors related to reaching program milestones on some of the product contracts in our backlog. These include our execution of R&D on programs and external factors, including customer inputs and the readiness of their training facilities.

The Defence book-to-sales ratio was higher this quarter at 1.08 times and it was 0.81 times for the last 12 months.

Lastly, in **Healthcare**, second quarter revenue of $30.4 million, was stable compared to Q2 last year and segment operating loss was $1.4 million in the quarter, compared to segment operating income of $1.3 million in Q2. We had a higher investment in SG&A to support a larger future business and we also had some higher expenses related to the recent launch of new products.

With that, I will ask Marc to discuss the way forward.

Marc Parent, President and Chief Executive Officer

Thanks, Sonya;

We continue to see good momentum with our training strategy, which is supported by secular growth trends across all our markets, and underpins CAE's investment thesis.

In **Civil**, the market fundamentals for commercial aviation remain supportive, with continued long-term passenger traffic growth, an expanding global in-service fleet of aircraft, and, specific to our business, a significant need to attract and create new pilots to meet long-term demand. CAE is the world-leader in Civil aviation training and is a brand that has become synonymous with training, and increasingly, with pilots. We’re maintaining very good momentum in a large addressable market, and as we look ahead, we expect to see more airline outsourcing opportunities materialize from a large pipeline of long-term training partnerships. We expect another good year for full-flight simulator sales and to maintain our leading share of the market.

In business aviation, we’ve significantly bolstered our position with the successful integration of Bombardier BAT, and with our recent strategic partnership with Directional Aviation Capital. In this market segment, CAE’s business is driven mainly by the ongoing training requirements that involve the already in-service fleet of business aircraft globally. We also expect to benefit from demand for training involving the entry into service of major large cabin business jets.

For Civil overall, we expect to perform a bit better than our original outlook, now with operating income growth closer to 30-percent for the year on strong demand for our training solutions, as underscored by a 1.45 times trailing book-to-sales ratio and a continued high ratio going forward—even on a growing revenue base.

In **Defence**, we continue to expect a stronger second half, which is a view supported by a healthy book-to-sales ratio in the quarter and a robust pipeline. Our revised outlook for modest growth for the year takes into account our lower year-to-date performance and our current expectations for reaching milestones on programs in backlog. We also expect to conclude several more contracts in the remainder of the year, and although we don’t control the timing of government decision-making, I take confidence in knowing that we’ve already been down-selected for most of them.

Our long-term prospects in the large addressable defence market remain positive and I’m encouraged by approximately $4.0 billion of defence proposals we have already written and that are currently in the hands of customers pending decision.

Finally, as previously announced with news of Gene Colabatistto's upcoming retirement, we are actively in the process of recruiting a new group president, specifically with a U.S. defence industry profile, who will be responsible for our Defence growth strategy and execution in our global markets.

And lastly, in **Healthcare**, I'm encouraged by the potential for CAE to leverage our leadership in aviation training and make healthcare safer. We're positioning the business to leverage the growing opportunities with hospitals, which now have major incentives in the U.S. specifically to address preventable medical errors, and they see simulation as a logical way to ensure their practitioners are adequately trained in procedures. The increased imperative on patient safety as recently highlighted in no small way by the World Health Organization initiating the first World Patient Safety day, is one important factor that gives me confidence in the long-term prospects for CAE in this market. We're continuing to roll-out the most innovative products in the market, and with our strengthened front-end organization, we continue to expect double-digit percentage growth this year.

In summary, our overall outlook for CAE this fiscal year is largely unchanged, with expected higher growth in Civil offsetting the lower expected growth in Defence. We benefit from a strong position and secular tailwinds in each of our core markets, and we look forward to superior top- and bottom-line growth in the years ahead.

With that, I thank you for your attention. We’re now ready to answer your questions.

Andrew Arnovitz, Vice President, Strategy and Investor Relations

Operator, we would now be pleased to take questions from analysts and institutional investors.