QUESTION AND ANSWER SESSION

Operator

Thank you very much. And once again, ladies and gentlemen, as reminder, to register for a question it is the one four on your telephone. You will hear a three-tone prompt acknowledging your request. If your question has been answered, to withdraw your question is the one followed by the three.

And we'll proceed with our first question from the line of Kevin Chiang with CIBC. Go right ahead.

Kevin Chiang, CIBC World Markets

Hi. Thanks for taking my question. Maybe just turning to civil margins, given you've kept your guidance for the year just wondering—it looks like you'll need to put up an 18 percent margin in Q4 to achieve that guidance. What type of line of sight do you have to reaching that? It does suggest a pretty big sequential improvement quarter over quarter. And then, just more broadly speaking, how do you see margins trending, say, over the next couple of years within civil? Are you kind of stuck here between the 16 percent to 17 percent or do you have line of sight to push above that as utilization rates improve here?

Marc Parent, President & Chief Executive Officer

I think, broadly, I think we're aware of what's required to be able to reach our outlook in the civil margins in the fourth quarter and we're confident on being able to get there. And the line of sight we have is, you know, obviously the product backlogs that we have, you know, the simulators that need to be turned into revenue and earnings this quarter are already in backlog, so we know what we'll get from that. We know what utilization in our training centres so far is and we have pretty good line of sight at this point of who's reserved into our training centres. So it's all of that. It's really, you know, as is the story for the longer term, the growth is going to come in, in terms of expansion of civil margins, really comes across that increasing utilization of our existing training centre network, increased utilization, that turning into... I mean the lever effect is quite significant and we continue to see that. At the same time longer term the restructuring plan we put in place, the process improvement plan that we put in place is well underway and I fully expect that, you know, as we expect starting in the next year, we will start to see those improvements flowing into improving the civil margin as well because it will give us another weapon in our competitive battle.

Kevin Chiang, CIBC World Markets

That's helpful. And maybe just quickly on defence, it sounds like the outlook continues to get a little bit more constructive for you. What revenue level do you need or what revenue growth rate do you need for defence margins to push above kind of the 12 percent to 13 percent you're guiding to this year? Do you have that in your backlog or do you need to secure some of these $3 billion of bids and proposals in order to push above that 13 percent range?

Marc Parent, President & Chief Executive Officer

I think the broader contributor to that, to the margin, is the percentage—it's not just the amount of orders, it's really the mix between products and services. Typically, for two reasons, typically, as we've highlighted before, typically services contracts. On the one hand we like them because it gives you a very good visibility on recurring revenues for the year to come and clearly you don't have to win them every year so you save on business proposal costs so you can bid on other programs, but typically they'll be lower margins. So depending on the mix between products and service you will, that will affect our margins going forward no matter what the level of revenue. But, you know, we continue, if look overall, what we see in our backlog and in the, you know, I've mentioned about $3 billion of bids out there with customers, you know, if we were to win our fair share, as we expect, we still see our margin expectations largely unchanged, which means in the 12 percent to 13 percent range.

Kevin Chiang, CIBC World Markets

That's helpful. I'll just back into the queue. Thank you.

Operator

Thank you very much. We'll go to our next question from the line of Ron Epstein with Bank of America Merrill Lynch. Go right ahead.

Kristine Liwag, Bank of America Merrill Lynch

Hi. Good afternoon, guys. It's actually Kristine Liwag dialling in for Ron. First, can you discuss the competitive environment? In the past few years we've seen U.S.-based defence contractors enter the industry so I'd like to understand maybe if you could discuss your win rate for civil training solutions and the contracts that you're pursuing and also pricing in that environment.

Marc Parent, President & Chief Executive Officer

I think the way I would characterize it, it remains the same as—it hasn't changed over the last few quarters. It's still pretty intense. I wouldn't call it insane, and I think I called it insane before, but it's not—it's still very competitive. It is certainly something that affects our product margins for sure as we battle this out. Having said that, that's what factored into the, that dynamic is what we've been predicted and assumed in our margin expectations and growth of the business. We continue to win our historical, you know, at least the last few years market share, about 60 percent, 70 percent, so we continue to win, but the competitive environment hasn't really changed is the way I'd characterized it.

Kristine Liwag, Bank of America Merrill Lynch

And then for civil products, can you discuss how many full-flight simulators you could build per year without adding incremental capacity and where you are today?

Marc Parent, President & Chief Executive Officer

Well, I think there are two things to that. There is no real—I would not characterize capacity being an issue with us to be able to ramp up production rate. And that will get even better with the process improvement plan that we have underway, which will allow us effectively to produce even the existing number that we have, that we win per year, using less assets.

Kristine Liwag, Bank of America Merrill Lynch

Great. Well, thank you very much.

Marc Parent, President & Chief Executive Officer

Thank you.

Operator

And will go to our next question from the line of Fadi Chamoun with BMO. Go right ahead.

Fadi Chamoun, BMO Capital Markets

Good afternoon. What percentage of the business, Marc, Stéphane maybe, like percentage of revenue or, even better, percentage of EBIT would you consider as a recurring sticky in a sort of changing demand environment like the aerospace cycle starts to flatten out here or even turn the other way? Just trying to understand the defensiveness of your business now, because that's obviously changed a lot in the past number of years.

Marc Parent, President & Chief Executive Officer

Okay. I think today, if you were to look at where we are in services, we're about, you know, business as a whole, about 50, close to 55 percent, 56 percent of our business is services, recurring services. And as we grow, clearly, you know, I would characterize civil, if I picked them apart a little bit, civil, we see that as clearly our growth story, and the growth is going to come about increased utilization in our training network. And that's really services so can expect that the recurring nature of our business should continue to grow. And that's a same thing in defence. We're bidding, now that we have the full capability, including the acquisition we made last year or this year of NFTC from Bombardier, the Bombardier military craft businesses, we're bidding as a training services integrator in the military market and really that allows us to go after much bigger recurring contracts of a services nature. So I would say that, if anything, our business is going to get more services, more kind of recurring nature of revenue as we go forward.

Fadi Chamoun, BMO Capital Markets

Okay. Maybe also on the CapEx, you know, you're on track for, I guess, about $100 million this year. Prior to this year you've averaged close to $150 million and given sort of the utilization rates that you're running at right now I'm wondering if you can venture into sort of what you'd think next year CapEx would look like. More close to that low end of the range of $100 million to $150 million or do you foresee opportunities here to invest a little bit more as we go into 2017 year or I guess into the end of this calendar year?

Marc Parent, President & Chief Executive Officer

Well, I wouldn't venture into a forecast for next year at this point but, suffice it to say that, you know, as I mentioned in my remarks, our number-one priority remains growth, and we're going to deploy the capital in such a way that makes sense in terms of being able to grow from an accretive point of view, first of all, and in line with our training services mission.

So as we see the opportunities we'll deploy the capital. We're not going to hold back based on that metric. Now that doesn't mean we're going to go back to the level we've seen in the past. So I'm not going to venture at this moment what we will do, Fadi. I think we'll focus on this year and as we get into the next quarter probably able to give you a number on that one.

Fadi Chamoun, BMO Capital Markets

Okay. Thank you.

Operator

Thank you very much. We will get to our next question from the line of Cameron Doerksen with National Bank Financial. Go right ahead.

Cameron Doerksen, National Bank Financial

Yeah, thanks. Just a question on the free cash flow and working capital. You had a very strong quarter for free cash flow. It seems like maybe a lot of it was driven by increasing payables. I'm just wondering if you can maybe talk about what happens, and that's, I guess, probably true for last several quarters, if you can just maybe talk about what has happened there and what your outlook is for working capital, either usage or generation, in Q4.

Stéphane Lefebvre, Chief Financial Officer

Yeah, Cameron, this is Stéphane. It wasn't actually increasing payables, it's actually we've received some payments ahead of the, ah, on some service contracts, down payments on some service contracts, so we record those as differed revenue. So it's not actually stretching payables. This is a—in the quarter we had received quite a lot of deposits on some service contracts. So that's where, ah, the reason why you see it as an increase in payables but it's in differed revenue. Look, I think overall looking at the results year to date, net cash operating minus all our net investments is $270 million better than what we had last year and so I think we're very pleased with that performance. And there is a number of reasons to highlight here, including, as Marc just talked about, the CapEx level was reduced, we generated more cash on our operations, and the cash invested in non-cash working capital actually reserved $46 million year to date compared to an investment of $129 million last year. So it's $179 million better. A lot of it is related to the way we collect our receivables. So I look at some of the statistics, the (inaudible) outstanding down from 55 days last year to 48 days this year. So it really is improvement across the board of pretty much all of our non-cash working cap components. So we're pretty pleased with that.

As far as your second question, the guidance, Cameron, we said, I think early in the year I said while I can see for fiscal 2016 again some investment in non-cash working cap but lower than in fiscal 2015. Given where we are after nine months we'll defiantly have a better performance than fiscal year 2015. I would probably even venture to say we'll probably be neutral on cash from working cap for this fiscal year. So it looks like a strong performance this year.

Cameron Doerksen, National Bank Financial

Okay. Very good. Thanks very much.

Operator

Thank you. We will get to our next question from the line of Benoit Poirier with Desjardins Capital Markets. Go right ahead.

Benoit Poirier, Desjardins Capital Markets

Good afternoon, gentlemen. Just to come back on the cash deployment opportunities, you announced a buyback for almost 2 percent of shares outstanding so I was just wondering in light of your strong free cash flow generation whether this reflects more of a cautious stance or do you foresee some growth opportunities that may require cash investment in fiscal 2017?

Marc Parent, President & Chief Executive Officer

Look, I think I'll start and I'll let Stéphane go. Look, I think we've historically been quite measured in our approach. I think that, as you saw from our dividends, we always, for last five years, increased our dividend every year, and though we don't have a set policy you can see, we can surmise a certain behaviour by our actions in terms of the kind of a yield we like. So now we're starting with an NCIB, which we think is another good way of returning cash to shareholders, in line with our third priority of doing exactly that. And it's a balance. It's a balance between our three priorities. I think the second one, deleveraging, I think we've achieved, now it's a question of maintaining an optimal or close to an optimal balance in our capital structure, which Stéphane can talk about. But our priority remains growth. So we, I think that we're—it's not that we're keeping our powder dry but I think we're in a very good position to be able to capitalize on the opportunities to not only keep pace with our customers—when we deploy CapEx, going back to Fadi's question, lot of that has to do with keeping pace with our customers as they grow their businesses, their airline business, and those that we have joint ventures with, but it's also to look at, you know, as we pursue our training partner of choice vision we see more opportunities to do outsourcing. So in some cases that will require capital. So it's really a balance, but it's—and maybe, Stéphane, you want to maybe just pick up on it?

Stéphane Lefebvre, Chief Financial Officer

Yeah, the only thing I would add is, I mean the training business is one that generates some good cash flow and it allowed us, in the few years, to deleverage quite a lot. You will probably remember, Benoit, right after the Oxford acquisition our net debt to cap was about 50 percent and so we were able to bring it down to 29 percent at the end of December. And we have quite a strong cash balance at the end of the quarter. So, to complete with what Marc was saying, we started from the stance of what do we need to offset dilution from our option and DRIP plans and putting in balance our cash position and the cash need over the next year, both in terms of CapEx and opportunities, as Marc mentioned, but also in terms of what we could repay in debt over the next 12 months. And without compromising the robustness of the balance sheet this is what we got approval from the Board to do at this point.

Benoit Poirier, Desjardins Capital Markets

Okay, perfect. And just looking at healthcare, you reached $28 million of sales, which is above your typical threshold of $24 million for profitability. Margins reached 5.7 percent. Any colour on what will drive margin upward going forward? Was there more question of ramping up your new line or more kind of a product mix impact in the quarter?

Marc Parent, President & Chief Executive Officer

Mainly mix. And within the quarter, just like anything else, depending, again, going back to mix, depending on which product you deliver in the quarter, and of course, as we've talked about before, Benoit, even though we've grown that business, it's still relatively small numbers compared to our expectation of how we're able to grow this business. So we are continuing to invest in SG&A and R&D to achieve that business. So that weighs a bit on margins. But overall we're—I've given you the outlook of growth in that segment and we feel quite on track to able to do that for the future.

Benoit Poirier, Desjardins Capital Markets

Okay. And last one, just related to pilot shortage in the U.S. The new rules that require a first officer to fly over 1,500 hours seems to be kind of a big distort market for pilots. So any thoughts on whether it's a positive net or negative net for simulation?

Marc Parent, President & Chief Executive Officer

Well, I think it does, it has a positive net for simulation in the sense that pilots, you know, when they actually do apply for airline job, they need to get type rating, and type rating is done in, ah, that type rating means you're getting essentially a license to fly an airliner, say a CRJ or Dash 8 or Boeing 737 or Airbus 320, whatever. So you do that in a simulator.

So we're actually getting lot of that activity right now. In Europe, a number of training centres are fully occupied with people doing type ratings for airline that are growing and taking on new pilots specifically going back to the 1,500 hour rule. I mean what helps us is not only on simulations but a little known fact is we are the largest flight training organization in the world. Our network of flight training schools, of which we have a very large one in Phoenix, Arizona, is clearly benefiting from that. So I think for sure it's a net positive for us.

Benoit Poirier, Desjardins Capital Markets

Okay. Thanks very much for the time.

Operator

Thank you. We'll proceed to our next question from the line of Turan Quettawala with Scotiabank. Go right ahead.

Turan Quettawala, Scotiabank

Yes, good afternoon. I guess my first question is also on the training centre utilization. The utilization obviously was very strong here in the civil side in the quarter. I'm just wondering if you can give us some sense of whether you expect that to continue in terms of like a mid-70s type utilization here.

Marc Parent, President & Chief Executive Officer

We haven't given any forecast on that, Turan. I think that it is possible for sure to get into those levels. I wouldn't predict when. Typically Q3 and Q4 are high quarters but I'm not going to venture to say how much it will get at this point

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Turan Quettawala, Scotiabank

Fair enough but, Marc, I guess like was there some kind of a blip here in the quarter or is this more of a longer-term trend?

Marc Parent, President & Chief Executive Officer

It's certainly not a blip. No, it's what we would have expected in terms of margin. When we gave the outlook for the year the utilization that we're getting and the resultant impact on the profitability and margins that results from that high utilization is pretty much right at what we expected. So there is no surprise from our side.

Turan Quettawala, Scotiabank

Okay, great. And I guess another question, I guess somewhat on the same lines of the aerospace cycle here, there's obviously a lot of worry out here in the market based on that, I'm just wondering, you have a great sense of what the pulse is of global airlines here; are you hearing anything from your airline customers? Is there concern that things could change for the worse here? Obviously we haven't seen any changes yet on the traffic level side but I'm just wondering if there's concern.

Marc Parent, President & Chief Executive Officer

Not that we're hearing. I mean, look, we're selling, I mean our business, which is the closest tied to delivery rates at the OEMs is our product business and if anything, as you see, we're selling more than we even thought for the year, which is a nice positive surprise. We still see the manufacturers still not going away from increasing delivery rates. Training demand is very healthy. The airlines have just had their most profitable year ever so, look, I'm going to knock on wood but I don't really—I'm not hearing that kind of worry that seems to be out there.

Turan Quettawala, Scotiabank

Great, thank you. Just a couple of clarification here for Stéphane. First of all, is it possible to parse out those ForEx gains between the segments?

Stéphane Lefebvre, Chief Financial Officer

Yeah, look, the $4 million FX gain that we disclosed in Q3 is not just for one single business or one single segment, it's spread across all the three segments. One thing, Turan, if I may, that I'll mention as well is that this is a gain, really ForEx gain on that we get typically on non-cash working capital accounts. We also have, within our joint ventures we have also a similar effect quarter to quarter and in Q3 we actually had the reverse. We had a $2 million non-cash working capital FX loss. That's not included in the $4 million that's disclosed in Note 10 to the Financials but that's actually in part of our results, our $12.9 million profit results that we've disclosed on the P&L. And so we didn't really get a $4 million FX windfall in the quarter, there was another FX loss in the JV line. And the other thing I'll mention is we also had some non-operating expenses that were higher than the normal and these were mainly pension related, share based compensation. We didn't call those out because one point in time you can't normalize for everything, but it sort of neutralizes entirely the $4 million of FX gain that you'd see there in Note 10.

Turan Quettawala, Scotiabank

That's helpful. Thank you, Stéphane. And just last question: Do you have a sense of the tax rate here for the full year? It's really moved around here this year, right?

Stéphane Lefebvre, Chief Financial Officer

It is. Well, look, last this quarter normalized for what I—I talked about the sort of the U.S. tax credit that we've had in Q3, normalized would be at 17 percent last quarter. Without the huge the big tax gain we've had we would been at 22 percent. So last year we were at 22 percent overall for the yea. And so it's tough for me to predict quarter to quarter but I continue using 22 percent to 23 percent, more probably 22 percent for planning purposes myself.

Turan Quettawala, Scotiabank

That's helpful. Thank you very much.

Operator

Thank you. Before we proceed to our next question, once again, on the phones, if you have any questions for the financial side it's the one four on your telephone. And our next questions from the line of Konark Gupta with Macquarie. Go right ahead.

Konark Gupta, Macquarie

Hi. Good afternoon. Just a clarification before I ask my question. On defence backlog, what's the split between product and services?

Marc Parent, President & Chief Executive Officer

We don't break it out but I think we can—we don't actually break out that number. Stéphane, I don't know if we can provide the colour on it?

Stéphane Lefebvre, Chief Financial Officer

I'll have to get back. I think it's probably 60 percent services.

Marc Parent, President & Chief Executive Officer

That would have been my guess, 60/40 percent services based. That's probably close.

Konark Gupta, Macquarie

Because you said the services on the military side is lower margin, right? And that's the area that you are expecting more growth basically.

Marc Parent, President & Chief Executive Officer

Correct.

Konark Gupta, Macquarie

Okay, thanks. So my question is actually more sort of broad-based. Obviously a lot of people look at ROCE here, right, and historically speaking you have been at, call it, 15 percent, 16 percent ROCE, and today, it's 11 percent. Now I understand some of that has gone with the change in the business mix after, call it, Oxford Aviation acquisition, et cetera. So let's say the normalized peak would have been something like 13 percent maybe ROCE. My question is like what will get you to get to that 13 percent ROCE number from 11 percent today with respect to your capital plans as well as obviously we are seeing right now there's been some overcapacity concerns in the commercial aviation market and the business aviation market indicators are not as solid as they used to be. So how will you go from 11 percent to 13 percent and like how much time that might take you? Is your plan for the next two, three years or are you talking more about five years? Because the utilization levels in your training centre is roughly same as 70 percent what you had when you had 15 percent, 16 percent ROCE I think.

Marc Parent, President & Chief Executive Officer

Well, look, I think that the path to return on capital employed is largely the path to returns, and returns are going to come, as we talked about, as increasing our utilization of our training centre network, and we believe we can do that. We believe we can capture a larger share in the training services market where, you know, contrary to our products market where we have about typically 60 percent, 70 percent market, in the training market, the training market itself is about six times larger. In that market we have about 25 percent market share, which is, by the way, a commanding share. We are the largest player by quite a large margin in that market. We believe, and I think we're starting to demonstrate, that there is an ability for us to continue to grow our market share in that segment, which is a market that itself is growing at the rate of passenger travel. So that's really where it's going to come from in large part. At the same time, we believe there is a growth story in defence. But I think largely the path is through increasing returns where, as you can see, our capital deployments have gone down over the past. I mean clearly this year we're down by about 50 percent year over year in terms of our CapEx. So, disciplined capital deployment in line with, keeping in line with, keeping pace with our customers, maintaining our existing assets out there, and looking at opportunities that are accretive, I think it's all going to come from that. There's no more secret than that.

Konark Gupta, Macquarie

So, Marc, in terms of CapEx basically, if you assume flat-line CapEx of, call it, $100 million for the next couple of years, do you think with the utilization that the trend we are seeing right now and if you assume you get more share in the training services, do you think something like 12 percent, 13 percent ROCE is achievable in the next two, three years?

Marc Parent, President & Chief Executive Officer

We're not going to go that far right now in terms of our outlook. But definitely 12 percent, 13 percent ROCE is definitely possible. But I think, look, we haven't had an investor day for a long time and I think that we're going to schedule, we have one scheduled at the end of March, and I think at that time I think we have an opportunity to maybe go deeper in all of our lines of businesses and get into some of the details which underlie what our view and our confidence is. It really goes to the heart of some of those questions that you're asking.

Konark Gupta, Macquarie

Okay. That's great, Marc. Thanks a lot.

Andrew Arnovitz, Vice President, Strategy & Investor Relations

Operator, I believe that's all the questions we have from investors and analysts this afternoon. I'd now like to open the Q&A session to members of the media.

Operator

Certainly. Ladies and gentlemen, once again, for the press or media, if you have any questions or comments you'd like to ask you can do so by pressing the one followed by the four on your telephone keypad to register your question. You will hear a three-tone prompt acknowledging your request. To withdraw your question you can press the one followed by the three. Once again, for the press and media, it is the one four to register a question.

And, ladies and gentlemen, once again on the phones to register any questions it is the one followed by the four to ask a question.

And, Mr. Arnovitz, we seem to have no questions queued up at this time. I'll turn it back to you.

Andrew Arnovitz, Vice President, Strategy & Investor Relations

Okay. Thank you very much, operator, and I want to thank all participants today for joining us on the call. I'd like to remind you that a transcript of the call can be found on CAE's website at CAE.com. And also appreciate that Marc mentioned the upcoming investor day on March 30th, an invitation for which will be going out shortly. Thank you very much.

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.
