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Turan Quettawala
Scotiabank

Ronald Epstein
Bank of America Merrill Lynch

Konark Gupta
Macquarie

QUESTION AND ANSWER SESSION

Operator

Your first question comes from the line of Steve Arthur with RBC Capital Markets. your line is open, please go ahead.

Steve Arthur, RBC Capital Markets

Thanks very much. I guess just wanted to ask about, I guess at the risk of oversimplifying, ask for a bit more colour on the relationship between the Civil utilization rate and Civil margins. The 79 percent utilization reported this quarter, obviously very strong number, haven't seen that for several years, and I do realize there's many moving parts that go into that but an overall 79 percent with maybe Civil margins higher than 17.2 percent. Is there some rule of thumb we should look at for the relationship between utilization and margins or some more specific way to think about that?

Marc Parent, President & Chief Executive Officer

I guess the answer, I think, Steve, it's not a perfect metric. Mix matters a lot. I mean we had, this specific quarter we had the higher proportion of dry, higher growth from dry training to wet training, although both increased, so that tends to, you know, for a higher level of utilization you get, if you like, less margin per unit of utilization. That's one of the answers. There's others specifically, you know, I'll let Sonya go through it but we had less product revenue this quarter and we also had a few hits on the commercial, well, the Civil margin this quarter. I think maybe you can just put more colour on that, Sonya.

Sonya Branco, Vice President, Finance & Chief Financial Officer

Sure. So, as you know on the portfolio of Civil business has varying levels of margin and so the mix matters, as Marc just said, as a higher proportion of dry than wet this quarter. And there was also a couple of drags on the margin this quarter, namely the contribution of LMCFT acquisition, which we just added on, was at a lower margin. And there was a higher than normal bad debt expense that we had to take on, one of our clients that filed for bankruptcy in the helicopter offshore industry, so if we take these into account really the Civil margin would have been closer to that 18 percent for the quarter.

Marc Parent, President & Chief Executive Officer

But generally, Steve, I think higher utilization, all things being equal, will be, as we've always said, will drive higher income, higher margins. And you could see, I mean we still, although the margin being what it is, I mean you still wind up in line with our outlook of low digit absolute SOI growth in the quarter.

Steve Arthur, RBC Capital Markets

And I guess just over time the trend towards more wet will continue presumably the LMCFT business will be a less of a drag and hopefully bad debt expense as well.

Marc Parent, President & Chief Executive Officer

That's our plan.

Sonya Branco, Vice President, Finance & Chief Financial Officer

That's right.

Steve Arthur, RBC Capital Markets

Okay. Thanks very much.

Marc Parent, President & Chief Executive Officer

And I think the other thing as well is that it's hard to look at such a correlation just on a three-month basis. I think it's probably going to be better to look at this over 12 months.

Operator

Our next question comes from the line of Cameron Doerksen with National Bank Financial. Your line is open. Please go ahead.

Cameron Doerksen, National Bank Financial

Good afternoon. Just a question on the Healthcare segment, I mean you sound fairly confident that you're going to be able to reach the targets that you've guided on revenue for Healthcare but it does sort of imply a 15 percent to 20 percent year-over-year increase in revenue in the coming quarters, which is a pretty significant increase. So I'm just wondering what gives you the confidence that you're going to get the orders in the remainder of the year that gets you to that double-digit plus type revenue growth.

Marc Parent, President & Chief Executive Officer

Well, you can imagine, we have some pretty detailed reviews on the business at all levels and to be able to support our outlook, to be credible in our outlook and what we're saying, and when we look at the factors, the factors why we were kind of low this quarter, there is some element of seasonality with our customers that we're finding out in the first quarter and that's very apparent. There's some timing of orders, things that just slipped out of the quarter which might have expected to hit, you know, for a matter of a day they go to next quarter, and that affects things when you're talking about this level of volume. And when we look at the rest of the year, the dynamics of the market hasn't changed. We have, you know, (inaudible), in terms of our, we know the customers pretty well that buy these products. There is a replacement cycle on these products. We get money from warranty revenue. So taking all of these factors together we feel pretty good about the outlook that we've given for the year. And the gross margins for these products are very good so when you look at the SOI being just slightly negative or neutral this quarter, you're really talking about because of the fact that revenue did not increase and our SG&A is higher because we continued to anticipate a much bigger market.

Cameron Doerksen, National Bank Financial

Okay. If I could just squeeze in just one really on tax rate, what's your expectation for the tax rate for the rest of the year?

Sonya Branco, Vice President, Finance & Chief Financial Officer

Yes. Hi, Cameron. It's Sonya. So in the quarter there was some distortion at a 0 percent tax rate and that was driven by some deferred tax assets that we had to take, that we had to book in Brazil. So, once normalized, the impact is about 14 percent, and that was driven by the mix of where we earn the income. Now the tax rate does tend to fluctuate from quarter to quarter. It's 14 percent this quarter, last quarter it was 24 percent. And what we've kind of given as an indication in the past is really that for the year it's best to look at it as a whole for the year of 22 percent to 23 percent and actually probably closer to 22 percent as a tax rate to use.

Cameron Doerksen, National Bank Financial

Okay. Thank you.

Operator

Our next question comes from the line of Benoit Poirier with Desjardins Capital Markets. Please go ahead.

Benoit Poirier, Desjardins Capital Markets

Given your comments about the little bit better working capital use there in Q1, just wondering whether we should expect a slightly stronger free cash flow for the year. I mean you were looking for a small consumption in working cap in fiscal 2017 but now could we see some positive movement in the working cap?

Sonya Branco, Vice President, Finance & Chief Financial Officer

So you're right, good performance in the quarter with good order intake. We've got some secured deposits on the contracts and we continue to improve DSOs and collections. Now we still do see for the year an investment in non-cash working cap. And what's driving that is the growth in the business, so we are growing the top line, and most of that growth will be coming from the services business and so therefore that requires some investment in non-cash working cap. So we'll hold on our outlook for some investment in non-cash working cap. Now when we go to free cash flow, we generally target about 100 percent conversion on earnings, and that can vary from year to year, sometimes it's a little bit lower, sometimes it's a little bit higher, but that's generally what we target of 100 percent conversion.

Benoit Poirier, Desjardins Capital Markets

Okay, perfect. And just with respect to your EBIT margin in the sense you were down versus last year, just wondering if you could provide more colour and whether you're confident with the kind of 12 percent number that you've been talking about.

Marc Parent, President & Chief Executive Officer

The backlog still supports the outlook that we've given of 12 percent to 13 percent in terms of the, ah, this outlook, the backlog, the contracts we have the backlog generally supports what we've been saying about 12 percent to 13 percent in terms of margin, and mix between products and services in the quarter will affect things. I mean you can see that the fact is revenue growth was higher in the quarter, so if you have a higher growth in revenue off a lower margin contract then overall, even though the absolute number is well in line, you know, we have a good increase in year-over-year absolute SOI growth in Defence, but it does yield that 11 percent margin.

Benoit Poirier, Desjardins Capital Markets

Okay, perfect. Thanks for the time.

Operator

Our next question comes from the line of Fadi Chamoun with BMO Capital Markets. Your line is open. Please go ahead.

Fadi Chamoun, BMO Capital Markets

Yes, good afternoon. I want to go back to the margin discussion a little bit, because you've added almost $100 million of revenues this quarter but that translated into a $10 million increase in EBIT. The incremental margin doesn't seem to be as high as we would have expected. Now I know there are a number of things, the acquisitions you've made may have distorted that a little bit, but can you talk us through why is the incremental contribution that low?

Sonya Branco, Vice President, Finance & Chief Financial Officer

Well, Fadi, we do see the higher utilization filtering through into the contribution, but it does matter what type of dry versus wet proportion, because not each hour of utilization is created equal.

There is a higher contribution in terms of wet versus dry and a lot of the growth in this quarter in the utilization rate came on dry revenues and so that affected the proportion of the margin. That in addition to those elements of drag kind of resulted in the 17.2 percent margin of the quarter.

Fadi Chamoun, BMO Capital Markets

Okay. And on the military side, I mean the increase of revenue was about $60 million, probably it's $20 million, $25 million I think from the Bombardier military acquisition that you've done, but the EBIT margin or EBIT, absolute EBIT was up just about $4.5 million. Is there a mix of contracts that we should be thinking about there or is that sort of the nature of the backlog that you have right now?

Sonya Branco, Vice President, Finance & Chief Financial Officer

As Marc mentioned, I think we have backlog that gives us visibility on the guidance that we've provided, 12 percent to 13 percent. It's really, so the growth, you are right, came partly from the NFTC program that we acquired last year, which we continue to grow, and that accounted for almost half of the growth, and what we've seen in the quarter is a higher proportion of services, and services tend to be at a lower margin and so that put some pressure on the margin. But as we see the proportion of products and services mix vary from quarter to quarter then we'll see the changes in the margins follow that.

Fadi Chamoun, BMO Capital Markets

Okay, that's helpful. Thank you.

Operator

Our next question comes from the line of Turan Quettawala with Scotiabank. Please go ahead.

Turan Quettawala, Scotiabank

Good afternoon. I guess I want to just touch upon quickly here on the SOI growth in Defence and maybe your guidance on that. So you had obviously some pretty decent growth here just looking at the total SOI on the Defence business. You're still keeping your guidance at mid, I guess, modest growth. I know modest can be a bit of, you know, not exactly a clear kind of target there but in terms of the numbers it would still suggest a bit of a decline as we go forward into the second half of the year. Am I reading that correctly or is there some upside to your guidance?

Marc Parent, President & Chief Executive Officer

We maintain the same outlook that we have, as we said in the press release, Turan.

Turan Quettawala, Scotiabank

Okay. So then I guess that implies that the numbers sort of have to go down in the second half of the year on a year-over-year basis?

Marc Parent, President & Chief Executive Officer

I think it depends what's your assumption on modest growth. And I'm not trying to be cute here but I think that, you know, modest growth continues to be and I wouldn't necessarily assume a decline.

Turan Quettawala, Scotiabank

Okay, thank you. That's helpful.

Marc Parent, President & Chief Executive Officer

Some of it is how much contracts that we can actually execute in the backlog. We win the contracts, we've got some pretty good orders, as you saw, book to bill has been good last quarter, so it really becomes at some point, you know, without sounding to be cagey, is how quickly can you actually execute on those contracts, because those contracts tend to be percentage, well, they'll be percentage of completion accounting, so depending on when you can actually, for example, finished the non-recurring effort of developing the engineering, which tends to drive a lot of revenue or income out of that, then when can you get the parts, and then when you get the parts you start booking revenue. So at this point, you know, we saw that in this quarter we were able to execute some contracts which resulted that but in the programs that we just won there will be a period of time where we'll be doing mainly non-recurring effort, which tends to be, you won't drive as much revenue from it. So that's why it's a bit hard for me to be more precise than that at this point. So we're maintaining our outlook.

Turan Quettawala, Scotiabank

Fair enough I guess. So is it fair to assume then that there was some maybe revenue that got pulled forward here into Q1?

Marc Parent, President & Chief Executive Officer

No, it's just mix, it's just timing. I think I have always said for many, many times that it's particularly military contracts that, you know, that tend to be larger in size than a typical civil contract, so there's more potential to be lumpy from quarter to quarter and it's better to look at this on a year as a whole.

Turan Quettawala, Scotiabank

Perfect. That's very helpful. Thank you for taking my question.

Operator

Our next question comes from the line of Ronald Epstein with Bank of America Merrill Lynch. Your line is open. Please go ahead.

Ronald Epstein, Bank of America Merrill Lynch

Hey. Good morning. Or good afternoon, guys. So maybe a couple of quick questions. When we think about the Defence business, is it possible for you to maybe walk through or give a little more colour on some of the Defence programs that might be on the horizon? So things we could look out for that are potential wins for you guys?

Marc Parent, President & Chief Executive Officer

We don't tend to do that in terms of general outlook, for obvious reasons, but I mean the type of contract we go after is training services integration contracts. We find that, you know, like for example that we just won with the U.S. Army fixed-wing contract. We'll go after that kind of contract in a big way because it allows us, obviously, to get a mix of products and services, which allows us to come with a solution that differentiates more. I mean if you look at overall, you know, we have 3.5 billion of business proposals out there to be selected, so I think that puts us in good place. I mean sometimes we're clear on who we are partnering with. Like, for example, on a T-100 program we're partnered with Aermacchi and Raytheon. Clearly C-130, anything to do with C-130J, P-8, I mean those contracts, you know, we're partnered respectively with Lockheed and Boeing in those cases. But specifically, barring, except the one I just mentioned on T-100, we tend not be very clear on it for competitive reasons.

Ronald Epstein, Bank of America Merrill Lynch

Okay. And then I don't know if you can give any more clarity on this but on the T-100 program itself, what is your position on that? I mean I think the Raytheon bid is pretty intriguing. So what are you providing in that bid?

Marc Parent, President & Chief Executive Officer

Ground-based training basically. Ground-based training.

Ronald Epstein, Bank of America Merrill Lynch

Okay. All right. And then maybe two more quick ones if I can. Can you characterize any changes, if any, there might not be any, that you've seen in the biz jet market? We've seen an acceleration of weakness in the large cabin biz jets; have you seen that at all in pilot training?

Marc Parent, President & Chief Executive Officer

Well, pilots tend to want to maintain their license, eh? So it takes a while typically before you will see a significant drop in utilization, especially on large cabin, before pilots want to lose their type ratings. So I wouldn't say that—we have seen some reduction in certain markets but overall we're maintaining, we're maintaining the level of activity that we've seen. And it has been, you know, we have done well on our large cabin jets. We continue to do pretty well. It's really a question of the activity level for us. I know, as I said in the call, that the level of deliveries seriously, I mean what we sense from what we're getting from the OEMs is, you know, with book to bills slightly below one, but it hasn't retranslated into a big difference for us in utilization when I look at the whole world and the mix between what we predominantly do, which is a mix of large and medium cabin biz jet training.

Ronald Epstein, Bank of America Merrill Lynch

Okay. And then maybe one last big picture question again while I've got you. Sort of in this post Brexit and unfortunately increased terroristic world in Europe, have you seen any impact on pilot training in Europe? Has that impacted that yet or at all?

Marc Parent, President & Chief Executive Officer

No, we haven't seen people dial down pilot training really. In new pilots, we haven't seen it. Not yet anyway.

Ronald Epstein, Bank of America Merrill Lynch

Okay, that's great. All right, thanks a lot.

Operator

Our next question comes from the line of Konark Gupta with Macquarie. Your line is open. Please go ahead.

Konark Gupta, Macquarie

Thanks and good afternoon, gentlemen. So my question is on balance sheet first. So can you please talk about some of the capital deployment opportunities in front of you, including potential acquisitions or maybe more buybacks? Given the leverage ratio it's kind of very conservative versus your long-term targets.

Marc Parent, President & Chief Executive Officer

I'll start with the latter end. I think our policy at the moment, approved by the Board, is that we're continuing with the NCIB and we're mainly going to use it for dilution. That's the plan we have in place and you saw what we just did with the dividend for the sixth year in a row, which means that if you look at the kind of returns that is, we're returning about $100 million of cash returns to shareholders this year. We think that's pretty good and it's in line, well, it gives you a kind of yield in a payout ratio in terms of the dividend, which it's kind of in line pretty much with what we have been doing, and we don't have a specific set policy on that but clearly you can see what we've done over the past few years and I think you would see a pattern. But our priority remains growth. We have done acquisitions on the smaller side, as you've seen. We acquired the NFTC contract from Bombardier last year at a fair price and I think we've been growing that contract. We're very happy with that contract. Same thing with Lockheed Martin Commercial Flight Training, which we concluded this past quarter. So, if we have the opportunity to do things like that, we would do that, but I don't see any big acquisitions on the horizon right now.

In terms of our capital, it's largely going to be market led, and what I mean by market led is we, in terms of adding simulators to our existing training centres in Civil, which has been and will probably continue to be the lion's share of the CapEx we deploy, barring one specific contract in the military which has to do with the $100 million we're spending this year on the U.S. Army fixed-wing contract, the Civil CapEx is really driven to support the growth of our existing customers and where we have partnerships, joint ventures, specific business aircraft where we see a good return because it's an underserved market either on that aircraft or that geography. And I think we've demonstrated or at least we have certainly shown that in the past that the investments that we've made in the past couple of years for sure are more immediately or more quickly accretive to return on invested capital. So those are the kind of priorities that we're going to keep doing and we'll, I think Sonya will want to keep our level of leverage within the bounds that we've set, and we're at the lower end of that bound right now, so we feel pretty good. So we're keeping our options open. And finally I would say that if we see opportunities to, you know, acquisitions of training centres or taking over assets from a customer that would like to outsource to a training centre, and it makes sense to us, that's the kind of deal we'd be going after, but it would be very value oriented.

Konark Gupta, Macquarie

And how about the Healthcare market, Marc? Do you see any potential for synergies by acquisition in that segment?

Marc Parent, President & Chief Executive Officer

Synergies on what, sorry?

Konark Gupta, Macquarie

On the Healthcare side would you acquire something there like you did METI before?

Marc Parent, President & Chief Executive Officer

Oh, I see. We might. I wouldn't consider anything big. We would, if we would see some specific product lines or client distribution channels, we look at those ever so often, but there is a proliferation of different players in this market, and I do agree with you that I think there would be a consolidation play to be had but, frankly, because it is a fragmented market, of which we are certainly in a leadership position, but frankly, values are really high and I think that our, we think that we can achieve the same thing organically.

Konark Gupta, Macquarie

Okay, thanks for that. And just quickly on the Civil side, Marc, the entire airline industry right now is kind of facing high industry capacity and some airlines, notably in the U.S., have become sort of more cautious on capacity growth. They are trimming capacity as we speak and I think some OEMs are also kind of curtailing production on, call it, wide-cabin commercial jets. So do you see any early signs of impact on demand for training or simulators because of those adjustments?

Marc Parent, President & Chief Executive Officer

No, we don't, because—well, we tend to take a longer-term view of this, but even the short term supports our outlook. I mean when we look at the next 10 years, even if we assume that the market is going to grow at, you know, commercial aviation training or, sorry, just capacity to grow at 4 percent or 5 percent, which has been going faster than that, but if we assume 4 percent to 5 percent growth over the next 10 years, I mean that's still going to support a minimum of new pilots, 25,000 a year, just to keep up the pace and keep up with the level of retirements. And it's not like they can extend the amount of retirements anymore. They've done that once already in the United States. There is only one time you can do that. So when we look at that we see an expanding market. And at the same time we—in the training market we're playing in a much larger market than just selling simulators and we have, although we are the largest player, we think we have a lot of headroom because we think we have about 25 percent market share in the $3.3 billion training services market. So I think that, as we said in the AGM speech this morning, I think there's potential for us to continue to grow market share in an expanding market itself.

Konark Gupta, Macquarie

I see. Thanks for the colour, Marc. Thank you.

Andrew Arnovitz, Vice President, Strategy & Investor Relations

Operator, we will now take the opportunity to use the time remaining to open the lines to members of the media and conclude the session with investors and financial analysts. So if you would please open the line to questions from members of the media?

Operator

Certainly. Ladies and gentlemen of the media, if you would like to register for a question or a comment, please press one four on your telephone keypad. Once again, if your question has been answered and you would like to withdraw your registration it's one three. One moment please as we field our next question.

Ladies and gentlemen, as a final reminder, if you would like to register for a question or comment it's one four.

Andrew Arnovitz, Vice President, Strategy & Investor Relations

Okay, operator, if there are no questions from members of the media, I think we'll conclude the call. I want to thank all participants for joining us this afternoon. I remind you that a transcript of today's call will be made available on CAE's website at cae.com. And of course the management team and myself are available one-on-one to answer any of your questions which may not have been answered during the call. Thanks very much.

Operator

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