Conference call: MARKETWIRE-CAE INC. Q2 CONCALL
Date: NOVEMBER 13, 2013

OPERATOR: Good day, ladies and gentlemen, and welcome to the CAE second quarter conference call. Please be advised that this call is being recorded. I would now like to turn the meeting over to Mr. Andrew Arnovitz. You may now proceed, Mr. Arnovitz.

ANDREW ARNOVITZ (Vice President, Strategy and Investor Relations, CAE Inc.): Good afternoon, everyone, and thank you for joining us today.

Before we begin, I need to read the following: Certain statements made during this conference including but not limited to statements that are not historical facts are forward-looking and are subject to important risks, uncertainties and assumptions. The results or events predicted in these forward-looking statements may differ materially from actual results or events. These statements do not reflect the potential impact of any non-recurring or other special items or events that are announced or completed after the date of this conference, including mergers, acquisitions or other business combinations and divestitures.

You'll find more information about the risks and uncertainties associated with our business in our second quarter fiscal 2014 MD&A and the Annual Information Form for the year ended March 31, 2013.

These documents have been filed with the Canadian Securities Commission and are available on our website at www.cae.com and on SEDAR. They have also been filed with the U.S. Securities and Exchange Commission under Form 40-F and are available on EDGAR.

Forward-looking statements in this conference represent our expectations as of today, November 13, 2013 and accordingly are subject to change after this date. On the call with me this afternoon are Marc Parent, CAE's President and Chief Executive Officer; and Stéphane Lefebvre, our Chief Financial Officer.

After comments from Marc and Stéphane, we'll take questions from financial analysts and institutional investors. Following the conclusion of that Q&A period, we'll open the call to members of the media.

Let me now turn the call over to Marc.

MARC PARENT (Chief Executive Officer, CAE Inc.): Thank you, Andrew, and good afternoon to everyone joining us on the call. As is customary on these calls, I'll first go through some of the highlights of the quarter, and then Stéphane will provide a detailed look at our results. I'll come back at the end to talk about the way forward.

We made solid progress during the quarter towards restoring operating margins in both our civil and military segments. Our operational focus yielded higher margins, more efficient working capital levels and significantly higher free cash flow which have enabled us to meet our objectives to reduce net debt below 40 per cent of capital.

We had a good quarter from an orders standpoint as well. Overall, we achieved a book-to-sales ratio of 1.47 on strong order intake in both Civil and Military and our consolidated backlog reached $3.9 billion. More than half of that involved civil contracts, and I'm pleased to report that our civil backlog now stands at a record $2 billion. This milestone is a true testament to CAE's market leadership and to the strength of the aerospace cycle that underlies the CAE investment thesis.

Looking specifically at Civil, we continue to benefit from robust activity for our full-flight simulators with 13 more sales in the quarter. Since then, we've booked another five, which brings us to 33 sales for the year-to-date.

We sold a Boeing 777 simulator to an undisclosed customer and we continue to build on our relationship with Indonesia's Lion Air with the sale of four full-flight simulators and options for four more in support of its Airbus A320 operations.

In civil training, we again relocated a high number of simulators during the quarter but we've now substantially bedded down the majority of simulators that were in flux during the first half of the year.

On the orders front, we signed long-term contract renewals with Jazz Aviation and Execaire for training services and we commenced training at our second civil simulation training centre in India, this time in New Delhi, with our joint venture partner, InterGlobe, which is the parent company of IndiGo Airlines.

For combined Civil, we received $515 million in orders this quarter for a book-to-sales ratio of 1.91 times. In Military, our business continued to be resilient. Revenue was essentially stable with last year, down 1 per cent, and we began to see the benefits of our restructuring in Europe. Our combined military segment operating margin reached 13.2 per cent.

In terms of new business, we booked orders for upgrades to the German Air Force's Tornado simulators as well as upgrades to the U.S. Air Force's KC-135 operational flight trainers, on which we also got an extension of our aircrew training services contract for that aircraft.

Also with the U.S. Air Force, we signed a contract to train all 1,500 of its pilots and sensor operators of the Predator and Reaper remotely piloted vehicles. Overall, we received $174 million in combined military segment orders this quarter for a book-to-sales ratio of 0.91 times.

I point out that this figure by itself doesn't give the full picture because it excludes a significant $121 million in negotiated options received in the quarter on U.S. Defense programs. It's noteworthy that these options have already been contracted but only get funded annually by the U.S. government. Taken together with funded orders, our book-to-sales for the quarter goes up to 1.54 times.

Second quarter military backlog was $1.94 billion and the total of our unfunded backlog represented an additional $371 million.

Looking now at New Core Markets, in CAE Healthcare, we had sales of our training centre management systems and patient simulators to customers in the U.S. and internationally. We also signed a contract with a medical device company in the U.S. to develop a cardiac procedure simulation solution.

In CAE Mining, we released a major update to our geological data management system and our Sirovision product. Sales during the quarter included our resource modeling and open pit planning software and our Sirovision 3D mapping software and stereo camera systems to customers in India, Australia, Canada and Peru.

With that, I'll now turn the call over to Stéphane.

STÉPHANE LEFEBVRE (Chief Financial Officer, CAE INC.): Thank you, Marc. Good afternoon, everyone. Consolidated revenue for the quarter was down 4 per cent year over year at 487.5 million and net income attributable to equity holders was 38.3 million, or $0.15 per share.

Income taxes this quarter were $8.4 million, representing an effective tax rate of 18 per cent compared to 21 per cent last year. The decrease in the effective tax rate from the second quarter last year was mainly due to a change in the mix of income from various jurisdictions and partially from an adjustment resulting from future changes in the U.K. statutory tax rate. Excluding the effect of these adjustments in the quarter, income taxes would have been $8.9 million.

We had excellent cash performance this quarter owing to higher operating cash flow and our continued progress to improve the way we manage our working capital. Non-cash working capital decreased by $58.3 million from last quarter, ending at 106.3 million. We had 119.7 million in free cash flow this quarter and 108.2 million year to date, which represents a 217 million improvement over last year.

Capital expenditures totaled 24.6 million this quarter with 15.2 million for growth and 9.4 million for maintenance. Net debt was 810.4 million as at September 30, 2013, down from 897.8 million as at June 30, 2013.

One of our capital allocation priorities has been to deleverage our balance sheet with the objective to reduce net debt from approximately 50 per cent of total capital in September 2012 to about 40 per cent. We had originally planned this to take 18 to 24 months, and I'm pleased to have reached our objectives in a little over a year. As of the end of the second quarter, net debt to capital was down to 38.7 per cent.

Now looking at our segmented financial performance, in our combined civil segments, second quarter revenue decreased 6 per cent year over year, reaching 269.3 million. Combined civil operating income was down 14 per cent year over year to 39 million for an operating margin of 14.5 per cent.

The quarter included a few positive and negative one-time items including the reversal of a provision, severance costs and costs related to the high level of simulator movements. Taken together, we still saw the civil margin move up in the right direction with some sequential improvement over last quarter.

Second quarter is seasonally slower for training and the utilization rate in our training centres was 62 per cent. This is low, even for the second quarter and reflects our ongoing ramp up of assets and centres and continued softer conditions in Europe and South America.

The rate compares to 65 per cent at the same quarter last year, and there's quite a lot of headroom that remains to be filled in the quarters ahead. The improvement in operating margins since last quarter on lower utilization underscores the progress made to improve efficiency and reduce costs.

In our combined military segments, second quarter revenue was down 1 per cent year over year at $191.1 million, and we generated 13.2 per cent operating margin. The margin improvement over last quarter mainly reflects the actions we've taken to reduce costs in Europe. In New Core Market, second quarter revenue was 27.1 million compared to 28.3 million in the second quarter last year. Operating income was 1 million compared to 2.2 million last year.

With that, I'll turn the call back over to Marc.

MARC PARENT: Thanks, Stéphane. We're very encouraged by the operational progress we've made in the second quarter, and many of the execution-related issues that impacted us at the start of the year are being resolved. The fundamentals of CAE's business remain strong, and we continue to be well positioned for growth.

In Civil, we've successfully maintained our leading position in full-flight simulator sales in a highly competitive market. With 33 full-flight simulator sales year to date, we're well on our way to reach our goal of a record 40 sales this year. The fundamentals of the aerospace cycle are strong, and we see an expanding market for simulation products and training inside of a highly regulated industry.

Aircraft OEMs have been steadily increasing production rates and have announced plans to increase them substantially more on the back of a record order backlog. Just this month, Boeing announced it will increase its production rate for the Boeing 737 program to 47 jets per month by 2017 from the current 38. This is significant because higher aircraft deliveries drive higher demand for full-flight simulators.

Demand drivers for training services and more enhanced training capabilities also remain strong as the skies become more crowded and aircraft more complex.

Just recently, the U.S. Federal Aviation Administration, the FAA, issued a final rule under the nation's Airline Safety and Federal Aviation Administration Extension Act of 2010 to ensure enhanced pilot training. And in Asia, Japan Airlines signed a contract with CAE to implement the first Multi-crew Pilot License program, the MPL, in that country. MPL is an advanced training and licensing methodology being adopted by a growing list of major airlines around the world. It is great testament to our credibility that an established carrier like Japan Airlines entrusts CAE with the nation's first MPL program.

The MPL methodology introduces pilot trainees to the multi-crew environment at an early stage of their training, and it puts more emphasis on simulation-based training to increase safety and efficiency. CAE is well positioned to support our customers as their partner of choice to find the right solutions for them to meet these new and evolving regulatory standards.

We've turned the corner in terms of getting civil unit margins back on track and we continue to expect the business unit's operating margin to reach high teens percentages in the second half of the fiscal year. We're in a prime position within a large and growing civil aviation market.

The landscape continues to portend well for CAE's business, especially as customers look for more comprehensive solutions to meet their simulation products and training services needs. We have deep industry knowledge, the widest range of product and service solutions and the broadest global reach.

CAE's brand is synonymous with safety and quality the world over, and testament to that are recent selections of CAE by airlines such as Lion Air, Etihad, Ethiopian Airlines, Turkish Airlines and China Eastern Airlines.

In Military, the market is still challenging from an order timing standpoint, but we're making good progress to cultivate new opportunities. We've been steadily increasing our tempo of activity to build up our bid pipeline.

In the first half of the fiscal year, we submitted over 1 billion of new proposals, which is nearly as much as we added to our bid pipeline all of last year. Our military business has proven resilient as expected with an improved margin, and we expect that to continue to be the case for the remainder of the fiscal year.

Longer term, the fundamentals of our military business remain conducive to growth. We have a well-diversified business geographically with a customer base of over 50 different National Defense forces and strategic positions on enduring aircraft platforms.

In New Core Markets, I remain encouraged by our prospects. We're continuing to develop new products and our global reach, and we've been identifying more opportunities for synergies with the rest of the company.

I want to conclude with a few words about the good progress that we've made against the three capital allocation priorities that we communicated last year. First, we've been continuing to fund growth opportunities through capital investments that are market led in nature. Growth capital is deployed to keep pace with our customers and where returns are highly tangible.

Second, we've continued to balance our investment in long-term growth with current returns for shareholders. To reflect our confidence in CAE's position and our outlook, we're pleased to have announced this morning a 20-per-cent dividend increase to $0.06 per quarter. This is the third time CAE has increased its dividend in the last three years.

Third, we've continued to improve the quality of our balance sheet. With net debt to capital now below 40 per cent, we are in an even stronger financial position.

And finally, I'm pleased with the operational improvements we've seen in the second quarter, and I expect that we'll see more performance improvements in coming quarters. We expect stronger margins and that we'll continue to benefit from our leading position in a robust aerospace market.

Thank you for your attention, and we're now ready to take your questions. Andrew?

ANDREW ARNOVITZ: Operator, we'd now be pleased to take questions from analysts and institutional investors.

Before we do, let me first ask that in the interest of fairness, that you please limit yourselves to a single one-part question and if you have additional questions after that, please feel free to re-enter the queue.

Operator, we’ll take our first question.

OPERATOR: Thank you. Ladies and gentlemen, if you would like to register a question, please press the 1 followed by the 4 on your telephone. You will hear a three-tone prompt to acknowledge your request.

If your question has been answered and you would like to withdraw your registration, please press the 1 followed by the 3. If you're using a speakerphone, please lift your handset before entering your request.

Our first question coming from the line of Steve Arthur with RBC Capital Markets. Please proceed with your question.

STEVE ARTHUR: Yes, great. Thank you. I just want to follow up on the planned trajectory for civil margins. You commented kind of targeting high teens for Civil in the second half. Is that largely a function of utilization? Or can you talk about the top say two or three drivers that get you there over the next few months?

And then just final point, or part of that I guess, just if there's risk to that outlook. Is it really a question of timeframe in that, that should be where the business gets to? And if it slips, it's a matter of quarters but not level?

MARC PARENT: Well, I could start by the last part, Steve. Thanks for the question. Yes, I think that time we'll stick to what we've said second half getting into the high teens; and it's mainly a question of operational leverage. And obviously, utilization has a play in that. If you look at the margins we have, and Stéphane can expand on them maybe, but because I think you've just got to see your way through some of this one-times or restructuring, things like that. But there's no doubt that apples to apples, our margins in training services are up by a couple of percentage points.

And when you take, you take that operational improvement that was achieved off, you know, really lower level of utilization. When you think about a business and training, which a lot of it is, as we've said before, a lot of it is, I wouldn't say fixed cost, but a large part of fixed cost. You think about the cost base being simulator, amortizations, buildings, utilities, things like that. So I guess a lot of this comes across as operational levers.

And I think noteworthy and what gives us confidence that, that will happen per the outlook that we've given is that clearly, summer is usually slow, and it has been slow, and we've moved simulators at the same time, which is the right time to do it during the summer because people aren't training. They're flying. That's why we did it. But if we look at September and we look at October, which is the two months that I have full data, the level of flying activity and training activity is back to a level that gives me confidence in our outlook.

OPERATOR: Our next question coming from the line of David Newman with Cormark Securities. Please proceed with your question.

DAVID NEWMAN: Good morning, gentlemen. Or good afternoon.

MARC PARENT: Good morning.

ANDREW ARNOVITZ: Good afternoon.

DAVID NEWMAN: Just on the margin outlook for the civil side, the high teens, is that an average over Q3, Q4? Or is that kind of where you would exit the year at that margin level?

MARC PARENT: I think we haven't been too specific on that one, but I think that we're confident that we're going to get into the high teens. And it'll be over the second half. I wouldn't get too much ahead of that, to be honest, but I think it's going to be steadily improving. There's no doubt.

DAVID NEWMAN: And Marc, you said that you've pretty much battened down the hatches on the sims that were in flux. So where did you end Q2 at? Where do you think Q3, Q4, when will it all be done and through the pressure that you're seeing on the severance from relocation costs subside?

MARC PARENT: Well, we've moved about two-thirds of the sims that we expected to move. So there's still about a third left. We'll do the exact numbers of what, Stéphane, that we've moved?

STÉPHANE LEFEBVRE: Well, in the second quarter we moved pretty much the same number of sims that we moved into first quarter and that was...

DAVID NEWMAN: That was (inaudible)?

STÉPHANE LEFEBVRE: Well, there were… Yeah, there were 20 in the first quarter. We said there were 20 in flux either being moved, ramped down or ramped up. And it's pretty much the same thing in the second quarter. We physically moved the exact same number of sims.

I see in the forecasts the number of moves ramping down towards the end of the year. So that'll be gradually a few more, a few less in Q3 and another, you know, a lot less in Q4.

DAVID NEWMAN: Okay, and if I just squeeze one more in, and it’ll be the final one, I promise, you've done 33 civil sims sold year to date, which is, congratulations, a good, great number. How has the market share been year over year? And just maybe a comment on the pricing environment, which I know was getting, you know, pretty tough for the guys like Lockheed Martin, et cetera? So what are you seeing on that front?

MARC PARENT: Well, in terms of the margin performance, to me, I don't think they've been very different than we've had in previous quarters. I think the competitive environment is pretty stable. So would you add anything to that, Stéphane?

STÉPHANE LEFEBVRE: No.

ANDREW ARNOVITZ: And David, it's Andrew. Just in terms of market share, it is in the 70-per-cent range, so still pretty typical of what we've been able to do in the past few years.

MARC PARENT: Yes, I missed that one, but yes, we're certainly in the high end of the… of our normal range.

DAVID NEWMAN: Okay. So pricing is looking okay, then?

MARC PARENT: Yes. Well, to me, it's conducive to the margin outlook that we've given. So it hasn't really changed much in terms of what we said.

DAVID NEWMAN: Okay, thanks, gentlemen.

MARC PARENT: You’re welcome.

ANDREW ARNOVITZ: Thank you.

OPERATOR: Thank you. Our next question coming from the line of Benoît Poirier with Desjardins Capital Markets. Please proceed with your question.

BENOÎT POIRIER: Yes, good afternoon. My question is about the margin on the military side. I was just wondering if you have any colour on what we should look forward in the second half on the military side. And maybe also discuss about what percentage of the revenues is already in the backlog for the second half? And how does it compare versus last year?

STÉPHANE LEFEBVRE: Okay, Benoît, well, let me just take you back to what I said a year earlier just before we started this restructuring program in Military. We had a portfolio running at about 10.5 per cent operating margin at the time. And you may recall this is when we've announced a large restructuring in Europe. And you may recall that I said for us to get back to the historical 15-per-cent margin we need two things.

We need to complete our restructuring program and we need higher volume.

If we look at where we are today in Military, we finished the quarter at 13.2-per-cent EBIT margin. That's pretty much where we are right now, Benoît. So I think for me, we've pretty much completed our restructuring program. It gave us a little over 200 basis points of incremental margins in Military. That's pretty much where… where we are right now. Now what will get us back to the historical mid-teens margins of 15 per cent-plus margins is more volume.

BENOÎT POIRIER: Okay, perfect. Very good colour. Thanks, Stéphane.

STÉPHANE LEFEBVRE: Okay.

MARC PARENT: The latter end of your question, Benoît, there on the revenue and backlog, I can't really get into the exact number. But I guess I would say that because we usually look at that at yearend and comparing year over year that's more of an appropriate measure. But I would say that certainly the revenue that we've got booked in backlog is sufficient to us to be confident about, you know, our outlook that we'll continue the same outlook in Military for this year, and that it'll continue to be resilient.

BENOÎT POIRIER: Okay, perfect. Thanks.

OPERATOR: Thank you. Our next question coming from the line of Milan Posarac, with Scotiabank. Please proceed with your question.

MILAN POSARAC: Good afternoon. I just had a question on the military training business with regards to the sequential margins. You guys mentioned that there's some lower margins on North American programs. And I just want to see if you can provide any colour on that? Was it just mix or, you know, competitive pressure? Any sort of light you can shed on that would be helpful. Thanks.

STÉPHANE LEFEBVRE: Well, I… you know, don't have the specifics for each program, but it would not be… You're looking at the TSM margins, right?

MILAN POSARAC: Yes.

STÉPHANE LEFEBVRE: But it's not… I don't think it results from any special competitive pressures. You look at the revenue in the second quarter went up quite significantly from 61 million to 60… over 67 million. And that's mainly in one of our training locations where in the previous quarter we had a couple of sims that were down for updates, so we've recovered. A lot of the pilots came back in training in that training centre. And that's the centre where we were able to generate more margins, but it's not as a result of competitive pressures.

MARC PARENT: The one thing I'd say about military margins in the training business, and we've said this I think before, it's not changes. Typically you would expect on a sustained rate lower margins in the training services business in Military, particularly in the United States. That's just what the market is.

MILAN POSARAC: Okay, thank you.

OPERATOR: Our next question coming from the line of David Tyerman with Canaccord Genuity. Please proceed with your question.

DAVID TYERMAN: Yes, good afternoon. My question's on New Core Markets. It seemed to take a step back in the quarter, negative sales growth and lower margins. Is this a temporary thing, or is something happening that this may be sustained at these kinds of levels for a while?

MARC PARENT: I think it's temporary. We've been hit, and to a certain extent, particularly on the medical side, we had some delays in Military specifically. I mean, some of the… you're into, in the military medical side you had some transactional sales, you know, lower unit cost simulators like mannequins, things like that that you had a lot of disruption leading up to the government shutdown. So that affected things.

So I would say it's more of a timing issue, particular around military program, some mix as well. I think we'll see that every so often. But overwhelmingly, I think we're affected this quarter, you know, particularly there, a little drop in Mining. But I think overwhelming it's on the Healthcare side. We're still expecting growth. And I still see the outlook for growth in the New Core Markets.

DAVID TYERMAN: Okay. And the lower margins reflect the lower sales, is that correct?

MARC PARENT: Yes, yes, because we… I mean, if you just take… what we've been doing is investing probably at the same rate of SG&A and R&D. And just take the lower revenue and you'll probably come around to the kind of SOI we generated.

DAVID TYERMAN: Okay, thank you.

MARC PARENT: Because we haven't stopped investing.

DAVID TYERMAN: Right. Thank you.

MARC PARENT: You’re welcome.

OPERATOR: Our next question is coming from the line of Anthony Scilipoti with Veritas Investment Research. Please proceed with your question.

ANTHONY SCILIPOTI: Thanks and good morning, or good afternoon.

MARC PARENT: Good afternoon.

ANDREW ARNOVITZ: Good afternoon.

ANTHONY SCILIPOTI: Thanks, guys. I'm looking at the note that goes through the revenues by geographic area, and I noticed there was a significant decline sort of quarter over quarter in the Asian countries and Australia. And I wondered how you could explain that looking at the different segments, because I hadn't seen that noted in any of the discussion about the margin change, or about the revenue change quarter over quarter. Thanks.

MARC PARENT: I'm actually looking at that as you're talking, Andrew. It's obviously something that grabbed our attention because we're looking at it.

ANTHONY SCILIPOTI: Note 13.

MARC PARENT: No, I know where it's at, but just looking at it right now.

STÉPHANE LEFEBVRE: Tony, I have to take a closer look at it. I know that the… there's been a change in the client mix compared to last year. It doesn't include, for sure, our subs. I think last year we had some bigger full-flight sales in China. So that could certainly explain the drop that I see in China, from 42 to 29. But I'd have to go back and give you the detail of it.

ANTHONY SCILIPOTI: I think why it caught my… also is that it was… it seems more localized in this quarter because if I look at the six-month number, it's not that bad, the decline. It’s actually up on the China basis, so it's really this quarter that China and other… and other Chinese countries and Australia is down sharply or, you know, somewhat.

STÉPHANE LEFEBVRE: We'll have to get back to you.

MARC PARENT: Yes, we'll have to get back to you.

ANTHONY SCILIPOTI: Okay, thanks.

ANDREW ARNOVITZ: I'll follow up with you, Anthony.

ANTHONY SCILIPOTI: Thanks, Andrew.

OPERATOR: Thank you. Ladies and gentlemen, as a reminder, to register for a question, please press the 1 followed by the 4.

Our next question is a follow-up question coming from the line of Benoît Poirier with Desjardins Capital Markets. Please proceed with your question.

BENOÎT POIRIER: Yes. Just on the simulation product, civil side, it seems that you've been impacted by timing of production milestone. So could you maybe provide more colour, and should we expect a stronger third quarter as a result?

STÉPHANE LEFEBVRE: I think, Benoît, yeah, there's been most of the time variance in the SP/C segments in relation to, really related to what we had as of advanced build in the shop. And in Q2, this is the quarter where we didn't have as much as we had in the first quarter and as much as we had in the second quarter of last year. With the number of full-flight orders that we've taken so far in the year, I mean there's no doubt in my mind that the revenue will ramp up in that segment.

BENOÎT POIRIER: Okay, excellent. And moving on the crew sourcing business, lower revenues this quarter, but I was wondering about, I thought that there would be also an opportunity to implement crew sourcing outside Oxford over time. So I'm just wondering if that business model is still representing an opportunity for you to expand the crew sourcing business elsewhere.

MARC PARENT: Yes, absolutely. I mean, we definitely believe that that's a great complement to the rest of our business, Benoît. And I think you're probably just seeing variations from quarter to quarter. But overall, we've seen quite a marked increase in that business since we’ve bought Oxford.

And I would expect as the changing landscape around the world relates to the availability of pilots, I think that particular business as well as our ab initio business will become more important to us in terms of being a supplier of pilots around the world, both train captains out of our crew sourcing business and second officers through our ab initio schools.

BENOÎT POIRIER: Okay. And maybe lastly, Marc, there's been a lot of talk these days about the drone application on the commercial side, a lot of positive things. I was just wondering if you could expand a little bit whether you see a lot of growth and where you're positioned going forward and, yes, what kind of opportunities for you, you see.

MARC PARENT: Well, look, we believe in it. There's no doubt that you saw this quarter we've announced and we had talked about that at our annual general meeting that we're very proud to have been selected by the U.S. Air Force for all of their training on the Predator and the Reaper drones. And that in itself is a very prestigious contract that underlies our expertise on UAVs.

And there's other contracts that we've won over the years in other countries that we haven't really talked about because the customers prefer it that way from a security standpoint. And we do R&D in that area. It's underlying, you know, sometimes we don't talk much about what we do in detail about when we say we spent over nearly 10 per cent of our revenue in R&D.

But I guess I can tell you one thing we have been testing is we've been testing a UAV ourselves in Northern Quebec, in Alma, and we've been demonstrating. We've been building expertise on operating in a UAV. And we've got small contracts, and I say small because it's part of our R&D effort just to demonstrate how we could use that.

And I think finally, I'd just point out to the MOU that we signed with General Atomics for pursuit of contracts in Canada and on the international version of the Predator.

And to me, that again underlies how other people see our expertise because General Atomics, as a manufacturer of those drones, clearly, you know, by partnering with us, basically they believe that we're going to be able to assist them the world over.

So look, I guess long answer, but I guess I believe in the future of UAVs.

BENOÎT POIRIER: Okay, very good. Thanks.

OPERATOR: Thank you. Our next question coming from the line of Scott Rattee with Stonecap Securities. Please proceed with your question.

SCOTT RATTEE: Good afternoon.

MARC PARENT: Good afternoon.

SCOTT RATTEE: Just a question on the unfunded military backlog. I think it was about 370 million in the quarter. So it represented a little bit of a jump up from where you'd been trending sort of 12 or 13 per cent over the last sort of year or two. Does that reflect the 121 in negotiated options? Does that sort of get into that number? Or is it something else that sort of made it spike?

MARC PARENT: No, that's exactly right. That negotiated options is unfunded backlog.

SCOTT RATTEE: Okay, perfect. Okay, that’s great. Thank you very much.

MARC PARENT: Thank you, Scott.

OPERATOR: Thank you. Our next question coming from the line of Kevin Chiang with CIBC. Please proceed with your question.

KEVIN CHIANG: Thanks and good afternoon. Just a point of clarification on one of the earlier questions. On the New Core revenue, sounds like the sequential, or the year-over-year decline reflected some timing and government shutdown issues. Is that revenue that's lost or can you make that back up in H2, i.e., that there'll be… there may be an acceleration in revenue in the back half of the fiscal year?

MARC PARENT: Well, you ask me to predict government contracts, but what I would tell you is by everything I know and how I can… how I see things is that revenue has moved to the right.

KEVIN CHIANG: Okay. Thank you.

MARC PARENT: You’re welcome.

OPERATOR: Our next question coming from the line of Tim James with TD Securities. Please proceed with your question.

TIM JAMES: Thanks. Good afternoon. Just wondering if my memory serves me correctly, there were some challenging conditions in the civil training market in South America that were cited last quarter. I'm just wondering if you can give us a bit of an update on that situation.

MARC PARENT: Yes. I think there's still a market softness out there. But you know, I was recently, less than a month ago, in Brazil, and I think things are picking up and our fortune’s that the airlines that we partner with I think are doing slightly better. And again, that's factored into the utilization pick up that we're starting to see and that we predict in the rest of the year. Not dramatic I would tell you, but certainly on the upside.

TIM JAMES: Okay, thank you.

OPERATOR: Thank you. Our next question is a follow-up question coming from the line of David Tyerman with Canaccord Genuity. Please proceed with your question.

DAVID TYERMAN: Yes. Stéphane, could you just give any thoughts on the tax rate and capex going forward?

STÉPHANE LEFEBVRE: Yes, I can. Well, you see, the tax rate was at 18 per cent in the quarter. There was nothing, I mean very little unusual in the quarter. We stated in the MD&A that there’s been an adjustment in the U.K. statutory tax rate has been enacted. So that gave us a little bit of an upside, but not a lot. So we're really looking at just a little south of 20-per-cent tax rate in the quarter.

What it gives us, David, is for the first six months of the year, about 22-per-cent tax rate. Last year, we were at 24. What I find is with the new rules under IFRS the tax rate tends to be more volatile than what I've seen before.

I think we… Personally I think we're going to be between 20 per cent, 22 per cent, 25 per cent. I continue using 25 per cent for planning purposes myself. So I think we'll see in certain quarters the tax rate being in the low 20s and trending to 25 per cent in other quarters for the rest of the year. As we expect growth from there on, I think the tax rate will increase.

DAVID TYERMAN: Okay. So for a longer term, would it be north of 25 per cent?

STÉPHANE LEFEBVRE: I don't believe that on the longer term, it'll be that high.

DAVID TYERMAN: Okay.

STÉPHANE LEFEBVRE: As I said, I used 25 per cent for planning purposes.

DAVID TYERMAN: Okay.

STÉPHANE LEFEBVRE: So I think that's where we are.

DAVID TYERMAN: That's helpful.

STÉPHANE LEFEBVRE: Yes, I'll pick up your question on capex. And I guess I'll go back on our capital allocation priorities that we talked about a few times. We continue investing, and there's some good growth opportunities out there. And we said right after the Oxford acquisition that we will continue investing in our network, which we do. But to the extent that we've got a secured demand in certain markets, we'll continue to do that probably at a pace very similar to last year.

And while we're on capital allocation, and that allowed us also to keep control on our spending, on our cash spending and deleverage the balance sheet. You've seen that we've reached our target of 40 per cent net debt to cap. The free cash flow in the first half of the year was robust where it was very, very strong. And we expect a strong free cash flow in the second half of the year as well, which is typical of what we see typically in a given year.

And that's why we've recommended to the board an increase in dividends. Cash flow, we're robust. It was not just a blip. The cash flow is strong, and we've got confidence in the … in the performance going forward.

DAVID TYERMAN: Okay. So it sounds like you think the capex will step up in the second half then to get you to sort of last year's level?

STÉPHANE LEFEBVRE: Well, it was first half of the year around 55 I believe, 55 million. Last year, we spent around 150, 160. So I think in the second half of the year, you may see more than the 55 but in a very similar range than last year.

MARC PARENT: So, yes, (inaudible).

DAVID TYERMAN: Okay. Okay, thank you. And just the last question. Marc, your sales used to be in Military around, combined, around, you got up to a peak of 900 million. You're back in the low 800s. Do you think there is enough business out there to materially get off the sort of low 800s level in the near term? Or is it just that there's so many headwinds that it's going to be difficult to move beyond that level for a while?

MARC PARENT: Oh, I definitely think the opportunities are out there. And this I've said before. I mean my whole thesis for remaining, you know, having a positive outlook on Military is based on that. The only thing I've always said is, yes, the competitive, and where there's more opportunities, some of it related to the increased use of simulation-based training, attracts more friends and, ergo, competitors.

DAVID TYERMAN: Um-hmm.

MARC PARENT: So there's no doubt that there will have more increased competition as opportunities grow, particularly since a lot of rest of defence you know is going south. But what I see in terms of opportunities and working with our head of Military with Gene Colabatistto who has a very, very solid grasp on our market is that we're seeing the opportunities out there. I mean, if you just look at how much we bid year to date and going back to what I was saying in my remarks, we bid this year, year-to-date effectively double what we bid all of last year. And it's not because we're widening the net that much. We are clearly going after stuff that's a little bit wider in terms of going into some of the adjacencies that we see, but not that much.

So I definitely see the opportunities are out there both in North America, in the U.S. specifically, and internationally. Again, the real thing here that's been dogging us is predicting – and we're not alone in this – predicting when these things will materialize in terms of because of government shutdowns, because of threats of sequestration, everything that causes uncertainty and disruption to people actually making decisions.

And if you look, we've been saying that for a while. And I think if you look at this quarter, yes, you’re going to have to take a view on the unfunded orders. But those unfunded orders I think, to me, they've been contracted. It's not a question of will they happen to me? It's just that we book funded backlog just that way; i.e. the government, the U.S. Government funds its whole total budget one year at a time. As we've seen because we've seen what happens when they don't reach agreement on the budget recently, so we've taken a conservative view.

But when you look at the total orders this quarter, when you add that backlog in that funded backlog, to me that's in line with the opportunities that are out there. So, clearly, long answer, but yes, I see the opportunities out there to go back to an order level that would sustain growth.

DAVID TYERMAN: Okay.

MARC PARENT: The question is… So I'm not too, I won't be pinned down as when because I don't (inaudible).

DAVID TYERMAN: No, fair enough. That’s helpful. Thank you.

MARC PARENT: You’re welcome.

ANDREW ARNOVITZ: Operator, I think we'll take the last 10 minutes here on this call, or as necessary to take questions from members of the media. I want to thank members of the investment community for their time with us today and for their questions.

OPERATOR: Thank you. Ladies and gentlemen from the press, as a reminder to register for a question, please press the 1 followed by the 4. One moment, please. Mr. Arnovitz, there are no questions from the media at this time.

ANDREW ARNOVITZ: All right. Then we'll conclude the call for this afternoon. I wish to thank all participants again and remind you that a transcript of today's remarks can be found on CAE's website at CAE.com. Thank you.

OPERATOR: Ladies and gentlemen, that does conclude the conference for today. We thank you for your participation and ask that you please disconnect your lines. Have a great day.

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