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CAE stands to gain from increase in global military spending

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Equity analysts says Montreal-based flight crew trainer is poised to receive significant bump to top-line revenue given breadth of contracts available

CAE Inc. could gain from an increase in global military spending as the threat of terrorism looms larger and some forecasters expect the United States to start committing more moneyto its armed forces after five years of cuts.

The Montreal-based flight crew trainer and simulator manufacturer, Canada's biggest defence company, is poised to receive a significant bump to top-line revenue in its military business given the breadth of contracts available as U.S. defence spending hits bottom this year and then picks up, equity analysts with Bank of Nova Scotia said in a recent research report. The bank raised its revenue growth estimates for the defence business to about 5 per cent a year for the next three years, twice as high as its previous forecast.

The United States' defence budget has reached an inflection point and is expected to grow over the next four years after falling for the past five, Scotiabank analyst Turan Quettawala said in the report. Regional threats in the Middle East and Asia Pacific and ongoing security concerns in many countries are also driving military spending higher, he said. The analyst based his assessment on meetings with defence officials and lawmakers in Washington, D.C.

"CAE is preparing to benefit from defence budget growth in various countries," Mr. Quettawala said, noting that management has expanded the company's product offering in various geographies and thereby improved its growth prospects.

Among CAE's contracts supplying about 30 defence forces around the globe, the company provides flying instruction for the U.S. military's Reaper and Predator drone programs. Independent forecasts suggest combined military and civil unmanned aircraft systems production will grow to 35,465 units by 2022 from 3,900 units in 2011, according to Altacorp Capital, driven by an increase in new uses for such drones in areas such as farming, news gathering and practice combat vehicles.

In an interview at CAE headquarters earlier this month, chief executive officer Marc Parent was equally upbeat about the company's defence and security business, noting that thesingle biggest thing on the minds of military commanders at the moment is maintaining troop readiness.

"The majority of governments in the West, Canada included, have been involved in 10 years or more of warfare [in the recent past]," Mr. Parent said. "They have the most battle-hardened military cadre they've had since the Second World War. So how do they maintain that edge of military readiness? By training."

CAE has announced more than $900-million worth of new defence contracts since the start of 2015, including a deal to provide recurrent training to U.S. Army and U.S. Air Force fixed-wing pilots. The agreement will see CAE train military helicopter pilots transitioning to planes, train entry-level army recruits to fly planes and set up a training unit for Army King Air aircraft.

With that and other similar comprehensive contracts, the company is positioning itself as a training services integrator, Scotiabank said. "This move is similar to the civil [aviation] business but better in the sense that it provides for long-term training contracts that allow CAE to get well entrenched with a particular military or a program," Mr. Quettawala said. The returns on this business are much better than civil, in part because contracts typically have "take-or-pay" features that allow CAE to get paid even if the capacity of its training facilities aren't used.

While higher military budgets should help CAE, a change in how defence departments actually spend money could also benefit the company while hurting other contractors such as those who manufacture aircraft. Simply put, it's far cheaper to run a simulator than it is to run a real plane. According to one U.S. Air Force estimate, a three-hour mission on a KC-135 aerial refuelling tanker costs about $20,000 (U.S.) while the same three-hour mission in a simulator costs about $900.

Scotiabank estimates that CAE will post defence business revenue of $947-million in fiscal 2017 with defence earnings per share of 97 cents. Competition will continue to pressure margins on earnings before interest and taxes, which are predicted at 13.2 per cent for the unit that year, Scotiabank said. CAE's current fiscal year, 2016, ends in March.

Margins and earnings quality continue to be a problem for CAE more broadly, according to analysts at ***Veritas Investment Research***. Over the past 22 quarters, CAE's gross margins have come down steadily from a high-30-per-cent to a mid-20-per-cent level, ***Veritas*** said. Meanwhile, the company has managed to meet or beat earnings in four of the past six quarters only because of one-time items, ***Veritas*** said. It recommends selling the stock.

Other analysts are more bullish on the company's prospects. National Bank Financial's Cameron Doerksen argues that global growth in air traffic remains strong, which will drive demand for pilot training in CAE's civil aviation business. Meanwhile, multiyear plane order backlogs at Boeing and Airbus means more simulators will be needed. The company needs to achieve better utilization rates for its training centres than the 64 per cent posted last quarter, he said.

CEO Mr. Parent acknowledged that there's room for improvement. But he insisted that after several years of significant capital spending and acquisitions to bolster its training capability, the company is now entering a new period in which it will reap the returns of its investments. Sustainable earnings growth is coming, he said.

"A lot of people see us, they call it a show-me story," Mr. Parent said. "I think we are showing them. And I think we'll continue to show them."