

CAE Inc.

In search of a firm, fixed-price fix – Reiterate Underperform

Reiterate Rating: UNDERPERFORM | PO: 26.00 CAD | Price: 25.86 CAD

Valuation stuck in penalty box on Defense headwinds

CAE's results marked a notable shift in investor attitudes toward CAE's Defense business. Since the print, CAE shares have remained depressed, trading down ~9% versus the S&P up ~3%. It appears that investors have started to appreciate just how prolonged and painful a turnaround in a defense segment can be ([as noted last quarter; see our report](#)). Since the announcement, we have not thought that the [L3Harris \(LHX\) Training business](#) (see our 12 September 2022 report) was a good acquisition for CAE, and we stand by that view. We reiterate our Underperform rating, as we expect CAE shares to remain in a penalty box until the legacy low-margin contracts are largely completed or CAE takes a charge and the contracts are fully de-risked. We update our estimates to reflect the completed Healthcare divestiture and stronger 4Q Civil adj. margins, slightly offset by continued defense margin headwinds.

Transformative contracts cannot come fast enough

Defense margins declined 114bps Y/Y. The decline was attributed to a ~200bps headwind from cost overruns on fixed-price legacy contracts and an additional ~100bps of under-absorption. We estimate that ~6% of CAE's defense revenue is tied to legacy contract work being performed at a ~10% loss, while management remains optimistic on reaching double-digit margins, with high-margin contracts replacing margin-destructive legacy work over the next six to eight quarters. However, history has taught us to remain more cautious. We expect the defense segment to reach high-single-digit margins by 2027/2028, given the new start delays to U.S. contracts under a continuing resolution and implied core business margins of ~6%.

Civil demand unquestionable, but where's the margin?

Civil posted another quarter of remarkable topline growth (up 20% Y/Y), with simulator utilization ticking up to 76% and backlog increasing 8.4% Y/Y. We continue to expect CAE to meaningfully benefit from the commercial air traffic recovery. The growth and demand are there. However, we continue to worry about this growth not translating into margin expansion. Adjusting for the AirCentre integration costs and other headwinds in the quarter, margins declined 540bps Y/Y. We would expect margin improvement as meaningful growth pairs with increased simulator utilization, Software as a Service (SaaS) growth, and strong demand in bizjet training. CAE instead held full-year civil margins flat. We note that we do expect 27% adj. margins in 4Q (due to timing of software revenue), but the one-off quarter does not imply that these elevated levels are the base for future quarters.

Estimates (Mar) (C\$)	2022A	2023A	2024E	2025E	2026E
EPS	0.84	0.88	1.20	1.25	1.55
GAAP EPS	0.45	0.71	0.95	1.25	1.55
EPS Change (YoY)	78.7%	4.8%	36.4%	4.2%	24.0%
Consensus EPS (Bloomberg)			1.15	1.32	1.59
DPS	0	0	0	0	0
EPS (CAE - US\$)	0.67	0.67	0.89	0.92	1.15
DPS (CAE - US\$)	0	0	0	0	0
Valuation (Mar)					
P/E	30.8x	29.4x	21.6x	20.7x	16.7x
GAAP P/E	57.5x	36.4x	27.2x	20.7x	16.7x
EV / EBITDA*	18.2x	14.2x	12.3x	10.6x	9.7x
Free Cash Flow Yield*	1.8%	1.7%	3.0%	3.3%	4.3%

* For full definitions of *IQmethod*SM measures, see page 5.

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Timestamp: 07 March 2024 03:00AM EST

07 March 2024

Equity

Key Changes

(C\$)	Previous	Current
2024E Rev (m)	4,617.9	4,482.2
2025E Rev (m)	5,042.1	4,804.1
2026E Rev (m)	5,443.0	5,181.4
2024E EPS	1.15	1.20
2025E EPS	1.35	1.25
2026E EPS	1.65	1.55

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Stock Data

Price (TOR / NYS)	25.86 CAD / 19.02 USD
Price Objective	26.00 CAD / 19.00 USD
Date Established	29-Nov-2023 / 29-Nov-2023
Investment Opinion	B-3-9 / B-3-9
52-Week Range	24.75 CAD - 33.88 CAD
Market Value (mn)	8,255 CAD
Free Float	99.7%
Average Daily Value	30.42 USD
Shares Outstanding (mn)	319.2 / 319.2
BofA Ticker / Exchange	YCAE / TOR
BofA Ticker / Exchange	CAE / NYS
Bloomberg / Reuters	CAE CN / CAE.TO
ROE (2024E)	8.1%
Net Dbt to Eqty (Mar-2023A)	66.1%
ESGMeter™	Medium

ESGMeter is not indicative of a company's future stock price performance and is not an investment recommendation or rating. ESGMeter is independent of BofA Global Research's equity investment rating, volatility risk rating, income rating, and price objective for that company. For full details, refer to ["BofA ESGMeter Methodology"](#).

iQprofileSM CAE Inc.

iQmethodSM – Bus Performance*

(C\$ Millions)	2022A	2023A	2024E	2025E	2026E
Return on Capital Employed	3.6%	4.6%	5.9%	6.7%	7.6%
Return on Equity	7.2%	6.4%	8.1%	7.9%	9.0%
Operating Margin	8.4%	11.3%	12.7%	15.3%	16.6%
Free Cash Flow	146	140	251	275	352

iQmethodSM – Quality of Earnings*

(C\$ Millions)	2022A	2023A	2024E	2025E	2026E
Cash Realization Ratio	1.6x	1.5x	1.5x	1.5x	1.2x
Asset Replacement Ratio	0.9x	0.8x	0.8x	0.9x	0.8x
Tax Rate	2.3%	21.7%	12.1%	22.0%	22.0%
Net Debt-to-Equity Ratio	66.1%	66.1%	60.8%	50.8%	40.2%
Interest Cover	2.2x	2.7x	2.7x	3.6x	4.2x

Income Statement Data (Mar)

(C\$ Millions)	2022A	2023A	2024E	2025E	2026E
Sales	3,371	4,203	4,482	4,804	5,181
% Change	13.1%	24.7%	6.6%	7.2%	7.9%
Gross Profit	956	1,166	1,255	1,345	1,451
% Change	24.9%	22.1%	7.6%	7.2%	7.9%
EBITDA	637	814	937	1,093	1,189
% Change	18.0%	27.9%	15.2%	16.6%	8.8%
Net Interest & Other Income	(131)	(178)	(207)	(205)	(203)
Net Income (Adjusted)	262	279	383	401	499
% Change	105.7%	6.8%	37.3%	4.6%	24.5%

Free Cash Flow Data (Mar)

(C\$ Millions)	2022A	2023A	2024E	2025E	2026E
Net Income from Cont Operations (GAAP)	150	232	317	412	513
Depreciation & Amortization	311	342	370	359	329
Change in Working Capital	23	(115)	(48)	(161)	(231)
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	(65)	(51)	(75)	0	0
Capital Expenditure	(272)	(269)	(314)	(336)	(259)
Free Cash Flow	146	140	251	275	352
% Change	-43.6%	-4.4%	79.6%	9.7%	28.0%
Share / Issue Repurchase	696	16	8	0	0
Cost of Dividends Paid	0	0	0	0	0
Change in Debt	642	(85)	(182)	(100)	(100)

Balance Sheet Data (Mar)

(C\$ Millions)	2022A	2023A	2024E	2025E	2026E
Cash & Equivalents	346	218	101	276	528
Trade Receivables	557	616	614	684	781
Other Current Assets	1,246	1,402	1,650	1,806	1,939
Property, Plant & Equipment	2,129	2,387	2,435	2,412	2,342
Other Non-Current Assets	5,301	5,814	5,610	5,610	5,610
Total Assets	9,579	10,437	10,410	10,788	11,200
Short-Term Debt	242	215	593	593	593
Other Current Liabilities	1,849	2,032	2,047	2,113	2,112
Long-Term Debt	2,804	3,036	2,458	2,358	2,258
Other Non-Current Liabilities	597	565	457	457	457
Total Liabilities	5,492	5,848	5,555	5,521	5,420
Total Equity	4,087	4,589	4,855	5,268	5,780
Total Equity & Liabilities	9,579	10,437	10,410	10,788	11,200

* For full definitions of iQmethodSM measures, see page 5.

Company Sector

Aerospace

Company Description

CAE provides simulation and modeling technologies and integrated training services to the civil aviation and military industries. In FY2020, about 42% of revenues were from simulation products and about 58% of revenue came from training and services. Although headquartered in Montreal, Canada, CAE has an unmatched global training footprint with 160 sites and training locations in over 35 countries, 135,000 pilots trained per year, and about 10,000 employees.

Investment Rationale

While we appreciate CAE's position to benefit from the global recovery in commercial air traffic and pilot shortage, we grow more concerned that CAE's significant capacity growth in simulators may be outpacing demand. Additionally, we see continued headwinds in the integration of the LHX business, as well as Defense margins underperforming for longer than CAE anticipated.

Stock Data

Average Daily Volume	1,589,937
Shares / Common - Dual Listed	1.00

Quarterly Earnings Estimates

	2023	2024
Q1	0.06A	0.24A
Q2	0.19A	0.27A
Q3	0.27A	0.24E
Q4	0.34A	0.45E

Key Changes

(US\$)	Previous	Current
2024E EPS	0.85	0.89
2025E EPS	1.00	0.92
2026E EPS	1.22	1.15

Healthcare divestiture on track for close by end of March

During the quarter, CAE officially moved Healthcare reporting to discontinued operations. Although discontinued, sales for the segment declined ~29% Y/Y, which resulted in a net loss of \$1.9mn. Management noted that the transaction remains on track to be completed by the end of 4QFY2024. We continue to view the divestiture as a strategic positive given that the segment historically contributed mid-single digits to total revenue and low single digits to total operating profit. Additionally, we would view the increased focus on the Defense and Civil aerospace segments as a positive.

Lower estimates on divestiture and margin pressure

For FY2024, we update our estimates to reflect the completed Healthcare divestiture, stronger 4Q Civil adj. margins driven by sales mix skewing to software and bizjet, slightly offset by continued defense margin headwinds. We increase our FY2024E EPS estimates to \$1.20 (from \$1.15). In the out-years, we expect lower margin improvement in Civil, while our Defense margin estimates remain unchanged. The lower margin estimates result in lower out-year EPS estimates, with FY2025E now \$1.25 (versus \$1.35 previously), FY2026E \$1.55 (versus \$1.65), and FY2027E \$1.85 (versus \$1.95).

Reiterate Underperform, maintain C\$26/US\$19 PO

We reiterate our Underperform rating, as we expect CAE's shares to remain in a penalty box until the legacy low-margin contracts are digested by the market or CAE takes a charge and the contracts are fully de-risked. We maintain our C\$26/US\$19 price objective (PO) and roll our valuation one year forward from CY2024 to CY2025. We derive our PO from 1.2x P/FCF (unchanged) relative to the S&P 500 on CY2025E. In our view, the 1.2x relative multiple fairly factors in the scarcity premium for a pure play on aircraft simulators, new defense wins, and the concerns over defense underperforming for longer and risk of not executing on Civil. Our US\$19 PO is derived by applying an FX rate of 1.35 to our CAD PO.



Price objective basis & risk

CAE Inc. (YCAE / CAE)

Our C\$26 PO is based on a relative 1.2x P/FCF multiple on CY24E estimates. In our view, the 1.2x relative multiple, slightly below average of 1.3x, fairly factors in the scarcity premium for a pure play on aircraft simulators, new defense wins, and the concerns over defense underperforming for longer and risk of not executing on Civil. Our US\$19 PO is derived by applying an FX rate of 1.37 to our CAD PO.

Downside risks to our PO: If there is another downturn in commercial aviation and pressures seen in the economy worsen, earnings could fare worse than our projections and the stock could underperform. If margins fare worse than we are expecting, there could also be downside to our valuation. M&A risk includes additional findings from the LHX acquisition.

Upside risks to our PO: sales and margins within civil, military and new core markets could exceed our expectations (if the aviation recovery is faster than we expect), and defense multiples could exceed their previous market multiple.

Analyst Certification

I, Ronald J. Epstein, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

US - Aerospace and Defense Coverage Cluster

Investment rating	Company	BofA Ticker	Bloomberg symbol	Analyst
BUY				
	AerCap Holdings N.V.	AER	AER US	Ronald J. Epstein
	Air Lease Corporation	AL	AL US	Ronald J. Epstein
	Booz Allen Hamilton	BAH	BAH US	Mariana Perez Mora
	BWX Technologies, Inc.	BWXT	BWXT US	Ronald J. Epstein
	CACI International	CACI	CACI US	Mariana Perez Mora
	Cadre Holdings Inc	CDRE	CDRE US	Ronald J. Epstein
	Crane Co.	CR	CR US	Ronald J. Epstein
	Embraer	ERJ	ERJ US	Ronald J. Epstein
	General Dynamics	GD	GD US	Ronald J. Epstein
	HEICO Corporation	HEI	HEI US	Ronald J. Epstein
	Howmet Aerospace Inc.	HWM	HWM US	Ronald J. Epstein
	KBR	KBR	KBR US	Mariana Perez Mora
	Leidos Holdings	LDOS	LDOS US	Mariana Perez Mora
	Leonardo DRS, Inc.	DRS	DRS US	Ronald J. Epstein
	Northrop Grumman	NOC	NOC US	Ronald J. Epstein
	Palantir Technologies	PLTR	PLTR US	Mariana Perez Mora
	Parsons Corporation	PSN	PSN US	Mariana Perez Mora
	RBC Bearings Inc	RBC	RBC US	Ronald J. Epstein
	Rocket Lab	RKLB	RKLB US	Ronald J. Epstein
	Teledyne Technologies Inc	TDY	TDY US	Ronald J. Epstein
	TransDigm Group Inc.	TDG	TDG US	Ronald J. Epstein
	Triumph Group	TGI	TGI US	Ronald J. Epstein
NEUTRAL				
	Albany International	AIN	AIN US	Ronald J. Epstein
	Boeing	BA	BA US	Ronald J. Epstein
	Garmin	GRMN	GRMN US	Ronald J. Epstein
	Hexcel Corporation	HXL	HXL US	Ronald J. Epstein
	L3Harris	LHX	LHX US	Ronald J. Epstein
	Lockheed Martin	LMT	LMT US	Ronald J. Epstein
	RTX Corp	RTX	RTX US	Ronald J. Epstein
	Textron	TXT	TXT US	Ronald J. Epstein

US - Aerospace and Defense Coverage Cluster

Investment rating	Company	BofA Ticker	Bloomberg symbol	Analyst
UNDERPERFORM				
	Bombardier	BDRBF	BDRBF US	Ronald J. Epstein
	Bombardier Inc.	YBBD B	BBD/B CN	Ronald J. Epstein
	CAE Inc.	YCAE	CAE CN	Ronald J. Epstein
	CAE Inc.	CAE	CAE US	Ronald J. Epstein
	Huntington Ingalls Industries	HII	HII US	Ronald J. Epstein
	Mercury Systems	MRCY	MRCY US	Ronald J. Epstein

iQmethodSM Measures Definitions**Business Performance**

Return On Capital Employed

Return On Equity

Operating Margin

Earnings Growth

Free Cash Flow

Quality of Earnings

Cash Realization Ratio

Asset Replacement Ratio

Tax Rate

Net Debt-To-Equity Ratio

Interest Cover

Valuation Toolkit

Price / Earnings Ratio

Price / Book Value

Dividend Yield

Free Cash Flow Yield

Enterprise Value / Sales

EV / EBITDA

Numerator

NOPAT = (EBIT + Interest Income) × (1 – Tax Rate) + Goodwill Amortization

Net Income

Operating Profit

Expected 5 Year CAGR From Latest Actual

Cash Flow From Operations – Total Capex

Numerator

Cash Flow From Operations

Capex

Tax Charge

Net Debt = Total Debt – Cash & Equivalents

EBIT

Numerator

Current Share Price

Current Share Price

Annualised Declared Cash Dividend

Cash Flow From Operations – Total Capex

EV = Current Share Price × Current Shares + Minority Equity + Net Debt +

Other LT Liabilities

Enterprise Value

Denominator

Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill

Amortization

Shareholders' Equity

Sales

N/A

N/A

Denominator

Net Income

Depreciation

Pre-Tax Income

Total Equity

Interest Expense

Denominator

Diluted Earnings Per Share (Basis As Specified)

Shareholders' Equity / Current Basic Shares

Current Share Price

Market Cap = Current Share Price × Current Basic Shares

Sales

Basic EBIT + Depreciation + Amortization

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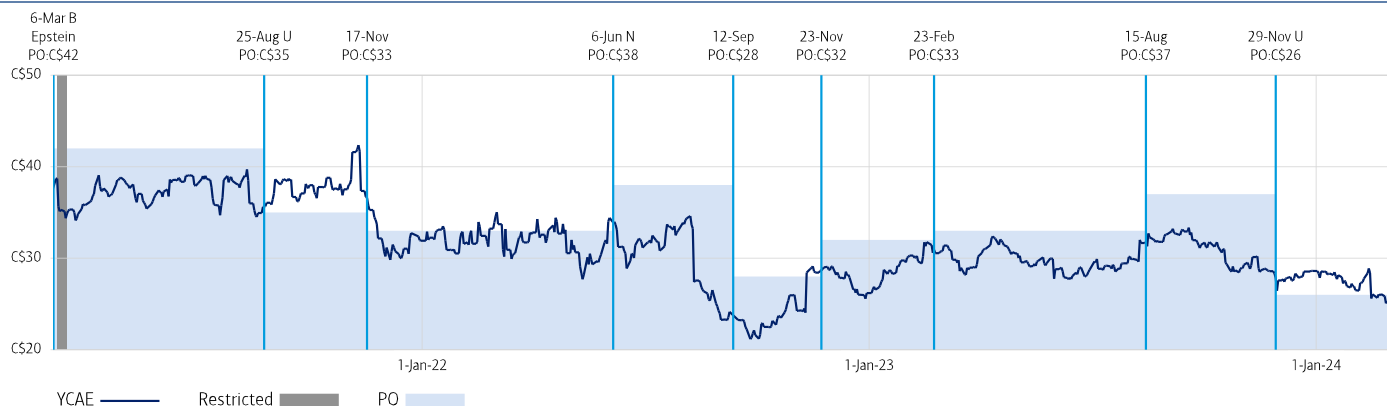
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Important Disclosures

CAE Inc. (YCAE) Price Chart



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CAE Inc. (CAE) Price Chart



The Investment Opinion System is contained at the end of the report under the heading "Fundamental Equity Opinion Key". Dark grey shading indicates the security is restricted with the opinion suspended. Medium grey shading indicates the security is under review with the opinion withdrawn. Light grey shading indicates the security is not covered. Chart is current as of a date no more than one trading day prior to the date of the report.

Equity Investment Rating Distribution: Aerospace/Defense Electronics Group (as of 31 Dec 2023)

Coverage Universe	Count	Percent	Inv. Banking Relationships ^{R1}	Count	Percent
Buy	31	62.00%	Buy	23	74.19%
Hold	11	22.00%	Hold	9	81.82%
Sell	8	16.00%	Sell	6	75.00%

Equity Investment Rating Distribution: Global Group (as of 31 Dec 2023)

Coverage Universe	Count	Percent	Inv. Banking Relationships ^{R1}	Count	Percent
Buy	1895	53.62%	Buy	1083	57.15%
Hold	832	23.54%	Hold	454	54.57%
Sell	807	22.84%	Sell	383	47.46%

^{R1} Issuers that were investment banking clients of BofA Securities or one of its affiliates within the past 12 months. For purposes of this Investment Rating Distribution, the coverage universe includes only stocks. A stock rated Neutral is included as a Hold, and a stock rated Underperform is included as a Sell.

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster ^{R2}
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

^{R2}Ratings dispersions may vary from time to time where BofA Global Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

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