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AIR.N - Q1 2023 AAR Corp Earnings Call

EVENT DATE/TIME: SEPTEMBER 22, 2022 / 8:45PM GMT

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Michael Frank Ciarmoli *Truist Securities, Inc., Research Division - Research Analyst*

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PRESENTATION

Operator

Good day, and welcome to AAR Corp. Q1 2023 Earnings Conference Call. (Operator Instructions)

Please be advised that today's conference is being recorded. I would now like to turn the conference over to AAR management for opening remarks. Please go ahead.

Unidentified Company Representative

Good afternoon, everyone, and welcome to AAR's fiscal 2023 First Quarter Earnings Call.

We are joined today by John Holmes, President and Chief Executive Officer; and Sean Gillen, Chief Financial Officer.

Before we begin, I would like to remind you that the comments made during the call may include forward-looking statements as defined in the Private Securities Litigation Reform Act of 1995. These forward-looking statements involve risks and uncertainties that could cause actual results to differ materially from the forward-looking statements. Accordingly, these statements are no guarantee of future performance. These risks and uncertainties are discussed in the company's earnings release and the Risk Factors section of the company's Form 10-K for the fiscal year ended May 31, 2022.

In providing the forward-looking statements, the company assumes no obligation to provide updates to reflect future circumstances or anticipated or unanticipated events. Certain non-GAAP financial information will be discussed on the call today. A reconciliation of these non-GAAP measures to the most comparable GAAP measures is set forth in the company's earnings release.

At this time, I would like to turn the call over to AAR's President and CEO, John Holmes.

John McClain Holmes - *AAR Corp. - CEO, President & Director*

Great. Thank you, and good afternoon, everyone.

I appreciate you joining us today to discuss our first quarter fiscal year 2023 results.

Sales for the quarter were down 2% from $455 million in the prior year quarter to $446 million, and adjusted diluted earnings per share from continuing operations were up 17% from $0.52 per share to $0.61 per share. Our sales to commercial customers increased 10% and our sales to government and defense customers decreased 19%.

In our commercial business, we remain encouraged by the continued recovery in air travel. As we indicated last quarter, the recovery has been strongest domestically, while Europe and Asia have lagged behind leading to global ASMs that are still about 30% below 2019 levels. This is most relevant for our parts activities, which are our most international.

Regarding our parts activities, we continue to see broadening interest in used material but the immediate demand for used parts continues to be impacted by the utilization of green time as well as the lack of material availability for certain high-demand assets. However, our new parts distribution activities continue to deliver meaningful growth.

While contracts signed prior to COVID still have not fully recovered, the overall growth is being driven by the series of distributorships that we've signed in the last 2 years. We continue to take share in the new parts distribution market and expect that growth to persist.

Finally, in MRO, our customers continue to signal strong demand for our services, and we expect our hangars to remain largely full for the rest of the fiscal year.

In our government business, year-over-year, we saw the full impact of the exit from Afghanistan as well as the completion of certain other programs. Sequentially, the decline was driven by reduced activity on certain short-term programs as well as a more normal level of parts sales to the U.S. government as compared to what we saw in Q4. As our recently awarded USAFE contract ramps up later this year and we win other contracts, we expect growth to resume in our government business.

Turning to margins. I am pleased to report that we delivered another strong quarter. Our operating margin was 6.9% on an adjusted basis up from 5.5% last year. We continue to demonstrate that the structural changes we made during the pandemic have resulted in a sustained margin improvement.

Regarding cash flow, we generated $7 million from operating activities from continuing operations. We saw opportunities this quarter to acquire high-demand assets that we expect to drive growth in our parts activities. This is an example of our ability to use our strong balance sheet to move quickly to take advantage of market opportunities.

We also repurchased $22 million of stock in the quarter under our share repurchase program. Even after the share repurchase, our net leverage was 0.4x EBITDA, and we continue to be exceptionally well-positioned to fund our future growth.

Turning to new wins. During the quarter, our Mobility Systems business was awarded a $173.5 million firm fixed contract from the U.S. Air Force to produce next-generation all-aluminum cargo pallets. We currently produce and repair the existing generation 463L cargo pallets and this award continues our support of the U.S. Air Force for many years to come. In addition, we were awarded a contract by the Norwegian defense logistics organization to provide parts for the Royal Norwegian Air Force P-8A fleet. This program builds on our successful strategic expansion into government programs outside of the U.S.

Finally, we announced the implementation of our AIRVOLUTION digital repair cycle management tool with Textron Aviation Defense. AIRVOLUTION is a customizable SaaS solution for optimizing the administration of aircraft component repairs and Textron Aviation Defense will rely on AIRVOLUTION to supplement and modernize its workflows for its repair orders.

With that, I'll turn it over to our CFO, Sean Gillen, who will discuss the details of the results.

Sean M. Gillen - *AAR Corp. - VP & CFO*

Thanks, John.

Our sales in the quarter of $446.3 million were down 1.9% or $8.8 million year-over-year. Our commercial sales were up 9.8%, while our government sales were down 18.7% due to the completion of certain government programs, including our Afghanistan contracts. Sequentially, our commercial sales were approximately flat, and our government sales decreased 16.2%.

Gross profit margin in the quarter was 18.4% versus 14.2% in the prior year quarter, and adjusted gross profit margin was 18.1% versus 16.1% in the prior year quarter. Gross profit margin in our commercial business was 18.2% and gross profit margin in our government business was 18.6%. In government, recent contract modifications that result in higher recovery on indirect costs as well as favorable cost performance on a contract drove the strong margin performance.

SG&A expenses in the quarter were $50.1 million. This figure includes continuing investments in our digital initiatives as well as $0.8 million related to investigation and remediation matters.

Net interest expense for the quarter was $1 million compared to $0.7 million last year, driven by higher interest rates, notwithstanding lower borrowings. As John indicated, we generated cash flow from our operating activities from continuing operations of $7 million. In addition, we funded $21.9 million of share repurchase.

Our balance sheet remains exceptionally strong with net debt of $70.7 million and net leverage of only 0.4x. Consistent with the last 3 quarters, we expect to continue to execute on our plan to deploy the full $150 million share repurchase authorization over approximately 2 years from the time of announcement.

Finally, we anticipate investing more significantly in inventory and rotable assets to support our growth.

Thank you for your attention, and I will now turn the call back over to John.

John McClain Holmes - *AAR Corp. - CEO, President & Director*

Great. Thank you, Sean.

As you know, we are in a period of macro uncertainty regarding growth and inflation. That said, commercial passenger traffic growth has historically been extremely resilient through economic cycles.

For AAR, as I indicated earlier, in our hangars, we expect to remain largely full, and even though the labor market remains tight, our partnerships with technical schools as well as other labor pipeline initiatives continue to serve us well.

In distribution, we are well-positioned to continue to add new lines and to benefit from the eventual recovery in flying levels in Europe and Asia. And in trading, engine green time will ultimately dissipate and new aircraft deliveries will eventually lead to retirement as a source of supply for more used material. This all should lead to an inflection point in the recovery of our trading volumes.

As we saw during the pandemic, our government business has also proven to be resilient during macroeconomic weakness. In addition, our fundamental value proposition to deliver commercial best practices at a lower price point to resonate even more loudly with our government customers during periods of budget tightening. As a result, we are confident in our ability to transition our government pipeline which remains very full into meaningful growth over time.

With respect to the near-term outlook, we expect both sequential and year-over-year growth in Q2. Specifically, we expect sales to be in between the quarter we just finished and Q4 of last year, and we remain optimistic for continued sequential growth throughout the balance of this fiscal year.

Over the long term, we are uniquely positioned as the leading non-OEM non-airline provider of comprehensive aftermarket solutions globally. We are well-balanced across commercial and government end markets, have the strong balance sheet to fuel market share growth and have a structurally improved margin profile that should translate into even greater value for our shareholders.

With that, I'll turn it over to the operator for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question will come from Mike Ciarmoli with Truist.

Michael Frank Ciarmoli - *Truist Securities, Inc., Research Division - Research Analyst*

Maybe, John, you kind of just gave some color on what you expect for the year with kind of the sequential growth throughout. Just -- and even, I guess, Sean talking about investing in inventory to anticipate the growth. I mean, are you still expecting sort of inflection in the second half of this fiscal year?

And then maybe can you give us a little bit of color on margins, certainly good performance in the quarter as you start to see more growth. Should we expect margins to hold firm? Or are there going to be any mix issues that we should be aware of?

John McClain Holmes - *AAR Corp. - CEO, President & Director*

Yes. Thanks for calling in.

So generally speaking, we -- if I think about the parts businesses in 2 areas, distribution, we expect to grow throughout the year. We've signed a number of agreements, those contracts are maturing. You're seeing continued recovery on agreements that were in place before COVID, and we expect distribution to grow throughout the year.

In terms of the aftermarket, the trading activities, I would say that, that inflection point, we need a couple of things to occur. We are seeing continued utilization of green time from our customers. So certain engine overhauls are being delayed that we would have anticipated by now because aircraft are on the ground, there's aircraft on the ground due to pilot shortages and other reasons. So that's pushing that inflection point out, but we still expect it to occur in the second half of the year.

And then as it relates to margin, we -- you've seen the full benefit of the structural changes that we've made, and that's put us around the 7% operating -- adjusted operating margin ballpark. As the parts businesses recover both in distribution and in trading, and that's the area where we still see the most opportunity for recovery and growth. Those businesses are margin accretive to where we are today. And so as the mix shift in that direction, ultimately, that should improve margins further.

Michael Frank Ciarmoli - *Truist Securities, Inc., Research Division - Research Analyst*

Got it. Got it. And then just on, I guess, investing in inventory for growth and even thinking about distribution, what are you guys seeing in terms of supply chain? Is there any challenges in terms of repairs or getting access to parts from your primary OEM suppliers? Or is that sort of lower on the radar screen for you guys behind maybe labor?

John McClain Holmes - *AAR Corp. - CEO, President & Director*

Yes. Good question. I would say labor is definitely the priority for us. But definitely in the distribution business, supply chain challenges are something that we're focusing on. But the team has done a really good job managing that. So it's had somewhat of an impact on the results over the last few quarters in terms of delayed deliveries, et cetera but an extended repair times. But overall, I think we've done a pretty good job managing through that.

Michael Frank Ciarmoli - *Truist Securities, Inc., Research Division - Research Analyst*

Okay. Got it. And then just last one for me. Any update, I know you called it out last quarter on the ADL drag kit. Any update there? Or kind of expectations, how we should think about that program?

John McClain Holmes - *AAR Corp. - CEO, President & Director*

I would say no meaningful update. The program continues to go well, and I know ADL was talking to a lot of interested customers.

Operator

One moment for our next question, and that will come from the line of Josh Sullivan with Benchmark Company.

Joshua Ward Sullivan - *The Benchmark Company, LLC, Research Division - MD & Senior Equity Research Analyst*

I know you mentioned you expect hangar demand for the hangars to remain relatively full. Can you give us any color there? Any changes in aircraft type? Is it still a narrow-body? Are there any dynamics there that are changing in the reservations? Or is it still kind of the same demand?

John McClain Holmes - *AAR Corp. - CEO, President & Director*

I'd say it's largely the same. The vast majority of our activity is around narrow-body maintenance. What I will say, and we pointed to this earlier in the year is that we've been able to change the relationship that we have with our customers to really drive a lot less seasonality in that business than we had seen before. We saw some so there were some lines of maintenance that went away during the summer because aircraft are flying, they'll come back in the fall, but it was much, much less significant than what we had seen in years past. .

And we're really pleased that our customers are working with us in this regard because we want to keep consistent aircraft and consistent workloads throughout the year so that we can maintain the labor force, but also drive efficiency and the improved margins that you've seen.

Joshua Ward Sullivan - *The Benchmark Company, LLC, Research Division - MD & Senior Equity Research Analyst*

And then one on the distribution side, who are you taking share from? Is it larger players or smaller mom-and-pop players? Is there a consolidation in the industry going on that you think will continue to trend for a while?

John McClain Holmes - *AAR Corp. - CEO, President & Director*

Yes. Many of the wins that we've announced in the last couple of years have come from the larger players. So that would be Aviall owned by Boeing, Satair owned by Airbus and then a handful of smaller but predominantly the larger players.

Joshua Ward Sullivan - *The Benchmark Company, LLC, Research Division - MD & Senior Equity Research Analyst*

Got it. And then just one last one on the Southwest relationship. Any movement there? Any dynamics there you can talk about or highlight for us?

John McClain Holmes - *AAR Corp. - CEO, President & Director*

The Southwest relationship?

Joshua Ward Sullivan - *The Benchmark Company, LLC, Research Division - MD & Senior Equity Research Analyst*

With the aircraft parting...

John McClain Holmes - *AAR Corp. - CEO, President & Director*

No, nothing new there. They remain a very large customer of ours and a great partner.

Operator

One moment for our next question. And that will come from the line of Ken Herbert with RBC Capital Markets.

Stephen Francis Strackhouse - *RBC Capital Markets, Research Division - Associate*

Sean, this is actually Steve Strackhouse on for Ken Herbert.

You've talked about the extended green time on engines, I believe. I was just wondering if you could touch a little bit further on the parts business, kind of your expectations for retirements for the rest of this year. Are you starting to see any tick up? Or are you starting to build inventory? I know you talked about building inventory, but just about kind of your expectations for the rest of the year?

John McClain Holmes - *AAR Corp. - CEO, President & Director*

Yes. Generally speaking, the green time, I think, is -- the green time is lasting longer than we would have anticipated. And the pilot shortage is definitely contributing to that in as much as you've got a number of aircraft that are on the ground because airlines don't have pilots.

I was with one of our larger customers earlier this week, and they shared with me that at the moment, they've got 50 aircraft on the ground as a result of pilot shortages. Well, that's 100 engines that they now have access to, to swap around and burn of green time. So that's definitely persisting longer than we would have imagined.

As it relates to overall supply, I would say nothing structural has changed. There's still plenty of demand and plenty of tightness out there in terms of used material supply. But we have, as we mentioned, and you saw it in terms of putting out some cash this quarter, we have found some unique opportunities, and we were able to move very quickly and capture material. And that's good for us, but I wouldn't say that it's an indicator of anything larger going on in the market.

Stephen Francis Strackhouse - *RBC Capital Markets, Research Division - Associate*

That's great color there. And then just one more, if I may. The inventories and contract assets were a use of about $40 million in cash in the quarter. And then going back to Q4, it looks like it was about an additional $20 million there as well. Can you just kind of talk about when you think that might normalize for this year and then just kind of free cash flow expectations on the year as well?

Sean M. Gillen - *AAR Corp. - VP & CFO*

Yes. I think some of the -- on the contract assets, we had some activity on our longer-term programs that weren't invoiced yet. I would expect those to get invoiced in the near term as I don't think you'd see that trend continue.

On inventory and rotable assets generally, as we talked about, we see opportunities, specifically on parts supply, which would show up in inventory to procure USM material, or to win new distribution business that would come with an upfront inventory buy. And then rotable assets will just support our PBH programs that are recovering and continue to recover with miles flown across the globe.

Operator

And we do have a follow-up question, and that will come from the line of Mike Ciarmoli with Truist.

Michael Frank Ciarmoli - *Truist Securities, Inc., Research Division - Research Analyst*

Sean, I know you went through this. I just wanted to make sure I had it. Obviously, the year-over-year decline in government defense, Afghanistan, but I think you also mentioned the sequential, it was down significantly, I guess, 17% or so. Did you say that was just some U.S. programs? I think I missed that. Just what was the driver there? And then I know you called for some strengthening as new programs kick in.

Sean M. Gillen - *AAR Corp. - VP & CFO*

Sequentially was twofold, which was some lower activity on some of the shorter-term programs that we've won over the last couple of quarters as well as reduced parts activity sales to the U.S. government. We had a pretty strong Q4 and just a lighter Q1.

Michael Frank Ciarmoli - *Truist Securities, Inc., Research Division - Research Analyst*

Okay. Okay. Perfect. I mean is that -- anything related to that reduced activity on the parts sales? Presumably, there's not much in the way of U.S. off tempo going on? Or any color you have there? I mean or just something that usually ebbs and flows?

Sean M. Gillen - *AAR Corp. - VP & CFO*

Mostly ebbs and flows, just a strong finish to our fiscal Q4.

Operator

And I'm showing no further questions in the queue at this time. I would now like to turn the call back over to management for any closing remarks.

John McClain Holmes - *AAR Corp. - CEO, President & Director*

I appreciate that. We want to thank everybody for your time and your interest, and we look forward to being back next quarter.

Operator

This concludes today's conference call. Thank you for participating. You may now disconnect.
