REFINITIV STREETEVENTS

EDITED TRANSCRIPT

AIR.N - Q4 2023 AAR Corp Earnings Call

EVENT DATE/TIME: JULY 18, 2023 / 8:45PM GMT

CORPORATE PARTICIPANTS

John McClain Holmes *AAR Corp. - CEO, President & Chairman of the Board*

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

CONFERENCE CALL PARTICIPANTS

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

Kenneth George Herbert *RBC Capital Markets, Research Division - Analyst*

Peter Osterland *Truist Securities, Inc., Research Division - Associate*

Robert Michael Spingarn *Melius Research LLC - MD*

PRESENTATION

Operator

Good afternoon, everyone, and welcome to AAR's fiscal 2023 Fourth Quarter Earnings Call. We are joined today by John Holmes, Chairman, President and Chief Executive Officer; and Sean Gillen, Chief Financial Officer. Before we begin, I'd 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 sector section of the company's Form 10-K for the fiscal year ended May 31, 2022, and Form 10-Q for the fiscal quarter ended February 28, 2023. In providing the forward-looking statements, the company assumes no obligation to provide updates to reflect future circumstances for 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 Chairman, President and CEO, John Holmes.

John McClain Holmes - *AAR Corp. - CEO, President & Chairman of the Board*

Thank you. Good afternoon, everyone. I appreciate you joining us today to discuss our fourth quarter and full year fiscal 2023 results. For the full year, sales increased 9% from $1.8 billion to $2 billion. Our adjusted diluted earnings per share from continuing operations increased 20% from $2.38 per share to a record $2.86 per share, which was driven by both sales, growth and our increase in adjusted operating margin from 6.3% to 7.5%. The strong performance reflects continued execution on our strategy to leverage our improved cost structure and capture growth in higher-margin activities. For the fourth quarter, sales were up 16% year-over-year from $476 million to $553 million. Sales to commercial customers increased 31%, while as expected, sales to government customers decreased 7% due primarily to the completion of certain government programs in the prior year quarter. Adjusted operating margin was 7.8%, up from 7% in the prior year quarter, and adjusted diluted earnings per share from continuing operations were up 15% from $0.72 per share to a record $0.83 per share. We saw further growth in our commercial parts activities as global air travel continue to recover.

In addition, as described in previous quarters, we saw engine green time availability continue to abate which drove additional engine shop visits and associated demand for engine parts, which represent the majority of our USM offering. USM supply remains tight, and our team continues to work to identify opportunities to acquire material to meet the robust demand. Further, our recent new parts distribution contract awards continued to ramp up. During the quarter, we did experience some delays from OEMs due to supply chain issues where we are working with our partners to receive the overdue material to ship against our backlog.

MRO demand remains strong and even though our hangers have been mostly full for some time, we were able to drive some additional volume through our footprint in the quarter. Labor availability remains tight, but our attrition levels have stabilized and our many partnerships with schools and other sources of [talent] continue to serve us well. In Integrated Solutions, although our government work was down, we saw better performance in our commercial power-by-the-hour programs driven by increased flying internationally and the improvements that we have made to that operation over the last few years.

With respect to cash, we generated cash flow from operating activities from continuing operations of $45 million. Our net leverage at quarter end was 1.07x EBITDA which was down from 1.35x at the end of Q3 on a pro forma basis for the [Trax] acquisition. As such, our balance sheet remains strong, and we have significant flexibility to fund our continued growth. Regarding new business, we announced in March that we had agreed to acquire 9 Boeing 757-200 passenger aircrafts equipped with 18 Rolls-Royce RB211 engines from American Airlines.

This investment provides us with feedstock to supply used [serviceable] material on the RB211 engine type to the 757 cargo market, which continued to be strong. It is also an example of the type of asset acquisition that our part supply team makes to support the demand for USM. In addition, I want to mention the announcement that we made yesterday regarding the expansion of our Miami airframe maintenance facility. Since making that announcement, we have received final approval from Miami-Dade Board of County Commissioners for the project. Our agreement with both the Miami-Dade Aviation Department and United Airlines will increase our volume by 33% at that site. This project meets all of the criteria that we have previously outlined for MRO capacity growth. Including expansion of an existing facility with government's financial support, favorable local market dynamics, labor market dynamics and a long-term customer commitment.

We expect a great break ground in our fiscal Q2 and construction will take approximately 24 months. AAR will be reimbursed by the Miami-Dade Aviation Department for the expected $50 million project cost. I would like to thank United Airlines, Miami-Dade County Mayor, Daniella Levin Cava, Miami-Dade Board of County Commissioners Chairman of Oliver Gilbert and the Miami-Dade Beacon Council for their partnership and making this important development a reality. Finally, I want to highlight that beginning with Q1 of fiscal '24, we will be separating the reporting of what is currently our Aviation Services segment into 3 separate segments. Parts Supply, Repair & Engineering and Integrated Solutions. This separation better reflects the way we manage the company and how we view the areas of growth. It will also provide enhanced disclosure and insight to the investment community and other stakeholders. With that, I'll turn it over to our CFO, Sean Gillen, to discuss the results in more detail.

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

Thanks, John. Our sales in the quarter of $553.3 million were up 16.2% year-over-year. Our commercial sales were up 30.7% driven by growth across our commercial activities and our government sales were down 7.1% due primarily to the completion of certain government programs in our previous fiscal year. We also saw a decline in defense distribution sales due to the timing of shipments from certain OEMs. Gross profit margin in the quarter was 19.5% versus 18.9% in the prior year quarter. Gross profit margin in our commercial business was 20% and gross profit margin in our government business was 18.5%. The strong commercial margin reflect the improved performance of our commercial integrated solutions activity that John mentioned and the contribution from Trax, which is a higher margin offering. SG&A expenses in the quarter were $70.8 million, excluding certain Trax expenses and other items that are detailed in the earnings press release. This figure was $64.1 million or 11.6% of sales. This percentage is up sequentially, but down year-over-year. In Q1, we expect a downward sequential cadence in SG&A similar to last year.

Net interest expense for the quarter was $4.7 million compared to $0.6 million last year, driven by higher interest rates and borrowings. Our effective tax rate in the quarter was 23.2% which was lower than we had anticipated due to certain state tax and other items in the quarter. We expect our effective tax rate to be approximately 25% to 26% in Q1 of FY '24. And approximately 27% for the full year FY '24. Cash flow from operating activities from continuing operations was $45.3 million. We ended the quarter with net debt of 203.6 million and net leverage of 1.07x EBITDA. In light of the Trax acquisition and other attractive opportunities to invest in our business, we elected not to repurchase stock during Q4.

We continue to have $58 million remaining on our stock repurchase program, and we'll evaluate both usage of the remaining authorization and expansion of the program over the course of the remainder of this fiscal year based upon alternative capital deployment opportunities. On that note, we are seeing attractive opportunities for investment in the USM market and they elect to deploy capital in Q1, which we expect will drive a use of operating cash in the quarter.

Regarding our resegmentation, we plan to file an 8-K today that provides financial results for the new segments for FY '22 on an annual basis and for FY '23 on a quarterly basis. The new parts supply of segment will consist of both our used serviceable material and distribution activities. The repair and engineering segment will consist of airframe MRO, component and landing gear MRO and engineering. And the Integrated Solutions segment will consist of our government programs and commercial power-by-the-hour component solutions and our software solutions such as Trax and Airinmar. Our Expeditionary Services segment consisting of mobility systems will remain unchanged. In addition to the segment changes, we are changing our measure of segment performance from gross profit to operating income. We have frequently heard from investors and analysts on the desire for greater transparency, and we hope these changes will be well received. Thank you for your attention. And I will now turn the call back over to John.

John McClain Holmes - *AAR Corp. - CEO, President & Chairman of the Board*

Great. Thank you, Sean. Looking forward, we expect the commercial market recovery to continue. Commercial air travel remains below pre-pandemic levels by most measures and in most markets. And as you have heard from many major airlines recently, their outlook for growth remains strong. This all means that we remain optimistic about the demand for our services. Specifically, we expect interest in USM to remain robust. Although supply is constrained, it has been improving, and we expect it to continue to improve as airlines take delivery of new aircraft and retirements increased. Notably, we do not expect additional USM supply to negatively impact our profitability. Instead, we believe it will lead to more growth as the availability of USM is currently a growth constraint. In distribution, we expect to win more new lines with more OEMs, which will drive more growth. The continued market recovery and OEM supply chain improvement will also provide tailwinds. In Airframe MRO, we expect our hangers will remain largely full throughout the year, and we are excited to be adding more capacity when the Miami expansion comes online. Additionally, we do have capacity available to meet growing demand in our component and [landing gear] repair facilities.

On top of that, we are also evaluating expansion at certain other of our airframe MRO locations where we have long-term customer interest and access to labor. Finally, in our government business, our F-16 program in Europe is not yet fully ramped and will be a more meaningful contributor in FY '24 and beyond. More generally, we remain confident that our value proposition in this market and our pipeline of opportunities will translate into additional growth over time. With respect to specific guidance, our operating environment remains exciting and dynamic and so we plan to continue our current practice of providing an outlook on a quarterly basis throughout our FY '24. On that note, we expect to see Q1 sales to be in -- to be in the low teens year-over-year driven by our commercial businesses and adjusted operating margins similar to what we just delivered in Q4. Looking ahead, we expect another year of margin expansion, albeit at a slower rate than the last 2 years. As you know, we are holding an Investor Day this Thursday, in New York, and we look forward to seeing you there to discuss our growth strategy, long-term financial targets and commitment to continuing to deliver shareholder value in more detail.

Before taking questions, I would like to take a moment to thank our team for delivering an outstanding year and our customers and other partners for supporting us. We continue to make our MRO operations more efficient added several key distribution wins, expanded support of our USM customers, added an important new capability with the acquisition of Trax and extended and upsized our credit facility in a challenging market. The result has been 9 consecutive quarters of adjusted operating margin improvement and record adjusted earnings while maintaining superb financial flexibility. Coming out of the pandemic successful was not inevitable. And once again, I'm exceptionally proud of our team. With that, I will turn it over to the operator for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Our first question comes from the line of Pete Osterland with Truist Securities.

Peter Osterland - *Truist Securities, Inc., Research Division - Associate*

I'm on for Mich Ciamoli. So first, I just wanted to ask on the Miami facility expansion. Once construction there is complete, what's the time frame for ramping up operations fully? And how many new hires will you need to add in order to support that additional capacity?

John McClain Holmes - *AAR Corp. - CEO, President & Chairman of the Board*

Yes, great question, and thanks for being on the call. Given the fact that we're expanding at an existing site where we've been operating for quite some time, once construction is complete, we expect ramp up to actually go very quickly. We anticipate hiring about 250 new people for this expansion. And again, one of the criteria for expanding [in this site] is that we feel we've got access to a very strong supply of labor which is certainly what we have in Miami. So we will be recruiting that talent well in advance of going ahead.

Peter Osterland - *Truist Securities, Inc., Research Division - Associate*

All right. Very helpful. And then I just had a follow-up on the margin outlook for the coming year. particularly given that you had some strong year-over-year growth this quarter, but SG&A, excluding the track expenses, the margin was about flat versus the prior year. I guess just what do you need to see in order to kind of see SG&A expenses improve and start to trend closer to the target you mentioned in the past of around 10% of sales. Is that still a viable target? Or are there any dynamics going on with wage inflation or anything else that has kind of changed the math there a bit?

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

Yes. I'd say (inaudible) remains the target to be at 10% of sales. And I think to get there, what we'll need to see is just continued leverage on the top line on both commercial and government sales. As I mentioned, Trax is slightly higher in SG&A, but it doesn't move the needle massively to the whole company. And even in this inflationary environment, we do still think that we can get to 10% of sales as we see more leverage on the top line.

Operator

(Operator Instructions). Our next question comes from the line of Ken Herbert with RBC Capital Markets.

Kenneth George Herbert - *RBC Capital Markets, Research Division - Analyst*

John and Sean, nice way to end the year. I wanted to first follow up, John, on some of your comments on the USM marketplace. It sounds like you're seeing more feedstock and it clearly sounds like you've got some opportunities very near term in the first fiscal quarter. Can you provide any more sort of granularity on where you're seeing the opportunities and maybe how we should think about investments either in the first quarter or across fiscal '24, specifically in the USM area?

John McClain Holmes - *AAR Corp. - CEO, President & Chairman of the Board*

Yes. Great question, and I appreciate you being on the call. Yes. I would say, generally speaking, we are seeing loosening in the U.S. supply and we have been able to deploy -- we're able to deploy capital throughout our FY '23 and here is we're starting off FY '24, we're presented with some unique opportunities. And again, as you know, that's one of our big advantages in the market is when these things come up. And there's still few and far between, we're able to move quickly. With respect to commenting on specific asset, types, et cetera, I'd prefer to stay away from that, given competitive dynamics. But we have a significant focus on engines. And we are talking to all areas of market, whether that's [lessors] that are going through portfolio changes. Airlines that are going for fleet changes, or even other brokers in the market that have assets available that meet contracts that we have to support.

Kenneth George Herbert - *RBC Capital Markets, Research Division - Analyst*

Okay. Very helpful. And based on your comments, it sounds like as you invest and you obviously transfer some of this feedstock into USM. You're not expecting -- or in fiscal '24, the guidance doesn't imply any sort of significant step down in pricing you're getting in the marketplace for the material, correct? I mean, it sounds like there's still enough of an imbalance that you should be able to get price on the USM at least through the fiscal year?

John McClain Holmes - *AAR Corp. - CEO, President & Chairman of the Board*

Yes. We definitely feel confident in maintaining our spreads throughout the year.

Kenneth George Herbert - *RBC Capital Markets, Research Division - Analyst*

Okay. Great. And if I could, just one final question. On the heavy MRO side, I mean, we continue to hear about capacity constraint and a number of maybe large captive airline operations may be getting out sort of -- getting out of the heavy MRO business to some extent. So I think your capacity additions make a lot of sense in your -- sounds like there's other opportunities there to maybe look to add capacity. How far out are you sold within -- or how does the backlog look maybe within the heavy MRO segment? And I guess, more importantly, it seems like if there was ever an environment for you to get better labor rates, it would be right now. So can you comment on sort of what you're seeing from that standpoint?

John McClain Holmes - *AAR Corp. - CEO, President & Chairman of the Board*

Yes. The commitment that we have from United that drove the Miami expansion and any of the other customers that we're talking to about potential other expansions, those are multiyear commitments. We're building permanent new capacity, and so we want to make sure that we align with that, so we are absolutely seeing airlines because they anticipate capacity shortage for some time, being willing to sign multiyear agreements with us. So that's encouraging.

As it relates to labor rates, I think we've touched on this over the last couple of calls. But generally speaking, we have a very productive dialogue with our airline customers about labor rates. And we have contract by contract work with the customers to adjust labor rates, our price to them to reflect the cost of labor that we've seen in the market. And we've been able to, in an inflationary environment, drive margin expansion in that business for maternal efficiencies, but also as a result of some of those discussions.

Kenneth George Herbert - *RBC Capital Markets, Research Division - Analyst*

Okay. And so is it fair to assume that as we get the new segmentation and we see the sort of the repair business broken out a little bit better, we should see some of that drop to your bottom line in terms of there's an area for margin expansion within that business in particular?

John McClain Holmes - *AAR Corp. - CEO, President & Chairman of the Board*

Yes, I mean we can talk more about that on Thursday when we're together. But broadly, we'll have visibility into the margins of that business. But I would say that our focus on margin expansion is not going to come through price increases to the customer. That's really just to keep us even with the increasing labor costs. The margin expansion that we expect to get over time is through investments in the facility. So Miami, leveraging the fixed cost structure there to add 33% more volume or deploying technology throughout our hangers, whether it's paperless drilling inspections, things like that to get ourselves more efficient inside the operation.

Operator

(Operator Instructions). Our next question comes from the line of Josh Sullivan with the Benchmark Company.

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

Just to kind of follow-up on Ken's question there. Looking at scheduled [care] needs at the MRO facilities and we hear about extended turnaround times. But when you look at the market, when do you think turnaround times kind of peak?

John McClain Holmes - *AAR Corp. - CEO, President & Chairman of the Board*

In terms of turnaround times in our own hangers, I mean we've been running a pretty steady operation for the last several quarters. So we feel that we're actually operating quite efficiently in the tenure. As it relates to component repair turnaround time, again, we feel good about the [TAT] that we've had in our own shops. We do outsource a lot of repairs, and we have seen those turnaround times increase. To say that -- to try to predict when that's going to peak and come down is difficult. But I think what we're hearing, and I'm sure you're hearing the same thing from repair providers, many of them are OEMs. We feel overall that the supply chain environment is improving. And so this should be a better year than last year for turnaround times.

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

Got it. And then maybe as far as Trax, any KPIs you can share that you've completed or you're looking to complete?

John McClain Holmes - *AAR Corp. - CEO, President & Chairman of the Board*

Nothing specific at this point, what I would say more generally is that we're roughly a quarter into the acquisition. It's going very well. The integration is on track or ahead of our plan. The team there remains extremely excited about the possibilities between our two companies. On Thursday, we'll provide more detail on the elements of the vision that we have for the Trax and AAR combination, and I feel really good about it.

Operator

Our next question comes from the line of Robert Spingarn with Melius Research.

Robert Michael Spingarn - *Melius Research LLC - MD*

I wanted to ask you just all this talk about heavy maintenance and maybe just to simplify it. Would you say with the unionization we've seen and all the traction that labor is getting in this constrained environment. Would you say that the wage spread between captive airline labor and your labor is widening?

John McClain Holmes - *AAR Corp. - CEO, President & Chairman of the Board*

I want to look at some data on that, but based on, yes, some of the increases that you're seeing as a result of the new contract, I would say, yes.

Robert Michael Spingarn - *Melius Research LLC - MD*

Okay. So this just provides additional tailwind for you?

John McClain Holmes - *AAR Corp. - CEO, President & Chairman of the Board*

Yes. And again, we've just announced an expansion. There are other expansions that we're considering, and we're only doing that where we're getting long-term commitments from customers.

Robert Michael Spingarn - *Melius Research LLC - MD*

Right, right. And then in terms of increased rates coming out of the OEMs, Boeing and Airbus starting to get those ramps, have you seen any impact from that in your business as more aircraft come through. I understand they're nowhere near where they're going to be. I'm just curious to the extent to which you might be seeing an effect from that.

John McClain Holmes - *AAR Corp. - CEO, President & Chairman of the Board*

I would say nothing broad or a trend at this point. The closest thing was just we are seeing a loosening -- a slight loosening of supply in the U.S. market. We are seeing more opportunities come up. But again, the coming growth from all quarters, again, whether it's lessors like airlines, et cetera. So we assume that the slight increase in production that you're seeing out of the OEMs is driving some of the fleet movement that's providing opportunities for us to acquire [Assets].

Robert Michael Spingarn - *Melius Research LLC - MD*

Okay. And then, Sean, for you, just with the parts distribution business impacting cash flows, if we were to exclude that or maybe look long term, is there a free cash flow conversion target that we should think about?

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

Yes. I mean we always thought about that over time as well. We've got to stay away from giving specific guidance on that, which is in terms of net working capital, as you mentioned, where we'll see volatility from time to time. We'll be around new distribution agreements, which generally come with an upfront capital outlay or USM opportunities as we kind of think saw back in our Q2 time period. We saw some big opportunities that we moved more aggressively on. But outside of that, we were obviously very focused on overall net working capital efficiency in AAR and AP as well. and continue to try to improve the cash flow profile of the company, which I think is part of the margin improvement that we've shown pre-covid today, I think you're seeing some of that improvement on the cash flow as well.

Operator

We have a follow-up question from the line of Ken Herbert.

Kenneth George Herbert - *RBC Capital Markets, Research Division - Analyst*

Sean or John, can you comment on maybe what percentage of the growth in the quarter was Trax or what that contribution was?

John McClain Holmes - *AAR Corp. - CEO, President & Chairman of the Board*

It was very modest. It was very modest this quarter, on track with expectations, very modest. And we would reiterate that we expect trax to be accretive to our FY '24 numbers.

Kenneth George Herbert - *RBC Capital Markets, Research Division - Analyst*

Okay. Okay. Great. And then I'm sure we'll get into more of this on Thursday. But as you look for fiscal '24, can you comment at least at a high level on sort of expectations for revenues or sort of low double digits a fair starting point as we think about the full year?

John McClain Holmes - *AAR Corp. - CEO, President & Chairman of the Board*

Yes. As we mentioned, we expect Q1 to be kind of mid-teens growth over Q1 -- I'm sorry, low teens growth over Q1 last year. And we'll talk a little bit more about long-range growth targets when we're together on Thursday.

Operator

Thank you. I'm showing no further questions in the queue. I would now like to turn the call back to management for closing remarks.

John McClain Holmes - *AAR Corp. - CEO, President & Chairman of the Board*

Great. Well, thank you very much. We appreciate the time and interest, everyone, and we look forward to seeing many of you on Thursday.

Operator

Ladies and gentlemen, this concludes today's conference call. Thank you for your participation. You may now disconnect.
