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AIR.N - Q3 2023 AAR Corp Earnings Call

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PRESENTATION

Operator

Good afternoon, everyone, and welcome to AAR's fiscal 2023 Third 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 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 in the Risk Factors 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 November 30, 2022.

In providing the forward-looking statements, the company assumes no obligation to provide update 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 Chairman, President and CEO, John Holmes.

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

Great. Thank you, and good afternoon, everyone. I appreciate you joining us today to discuss our third quarter fiscal year 2023 results.

Before I comment on the results, I would like to highlight the acquisition of Trax that we announced yesterday. This is a combination that we have been thinking about together with Trax for almost 10 years, and we have worked carefully with the founders on the strategic vision for the combined organization.

Trax is one of the leading third-party providers of MRO and fleet management software globally. It supports over 100 customers and approximately 5,000 aircraft, providing software for managing the entire spectrum of maintenance activities. These activities include many things, such as inventory planning and purchasing, maintenance scheduling, engineering, work order processing, mobile task cards, electronic logbooks and personnel management.

Additionally, Trax is a critical piece of software as it serves a system of record required for airlines and MROs by the FAA and other global regulators.

For over 20 years, Trax has competed successfully against much larger players and has established itself as the leading independent provider of maintenance ERP software. The success in the market, given their size, speaks to the strength of the product, and we believe that with AAR's backing, will help them compete even more effectively.

For AAR, this acquisition accelerates our digital strategy, adding a platform for bringing additional software tools and analytical solutions to our customers and creating a unique channel to offer AAR products and services. In addition, it squarely furthers our stated objective to add differentiated IP-based higher-margin solutions to our aviation aftermarket offerings.

The Trax leadership team will remain with the business, and we will retain the Trax brand and identity in the marketplace. Turning to the quarter. Sales were up 15% from $452 million in the prior-year quarter to $521 million, and adjusted diluted earnings per share from continuing operations were up 19% from $0.63 per share to $0.75 per share.

Our sales to commercial customers increased 28% and our sales to government customers decreased 3%, reflecting the prior wind-down of certain programs last fiscal year. Sequentially, sales to [commercial] (added by company after the call) customers increased 9% and sales to government customers increased 15%. Our commercial parts activities continued the momentum that we described last quarter.

New parts distribution benefited from the continued recovery in commercial flying as well as the recent contract wins, which were also contributing to the results. And as expected, the investments that we made in our USM activities last quarter have already generated early returns. We remain focused on additional opportunities to deploy capital to support our parts activities.

In MRO, we continued the strong performance that we have seen for the past several quarters, remaining nearly at capacity. And I'm pleased to report that on our government business, we were able to identify short-term opportunities that drove sequential growth in the quarter.

We also delivered another strong quarter with respect to profitability as our operating margin was 7.6% on an adjusted basis, up from 6.7% last year and consistent with the strong performance in Q2. This was driven by our revenue growth and our ability to continue to leverage the lower cost structure that we established during the pandemic. With respect to cash, we generated cash flow from operating activities from continuing operations of $17.4 million during the quarter. Our net leverage at the end of Q3 was 0.8x EBITDA. Pro forma for the Trax acquisition, our net leverage was 1.35x EBITDA. At this level, we continue to have significant balance sheet flexibility to further fund our growth.

With that, I'll turn it over to our CFO, Sean Gillen, to discuss the results in more detail.

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

Thanks, John. Our sales in the quarter of $521.1 million were up 15.2% year-over-year. Our commercial sales were up 28.1%, driven by growth across our commercial activities. Our government sales were down 3% due to the completion of certain government programs in our previous fiscal year. Sequentially, our commercial sales were up 8.9% and our government sales were up 14.9%.

Gross profit margin in the quarter was 18.1% versus 17.8% in the prior-year quarter. Gross profit margin in our commercial business was 18.1% and gross profit margin in our government business was 18%.

The margins in the quarter reflect continued strong performance in our Parts Supply and MRO activities as well as favorable adjustments on the government contracts related to improved recovery on overhead costs in contract performance.

SG&A expenses in the quarter were $56.7 million. This figure includes a net $4 million related to certain items that are excluded from our adjusted financial results. These items are detailed in the earnings press release. Excluding these items, our SG&A decreased to 10.1% of sales in the quarter, which drove our adjusted operating margin performance of 7.6%.

Net interest expense for the quarter was $3.5 million compared to $0.6 million last year, driven by higher interest rates and borrowings. Our effective tax rate in the quarter was 26.8%. We would expect our Q4 effective income tax rate to be approximately 28%. Cash flow from operating activities from continuing operations was $17.4 million, including a $25 million reduction in inventory in the quarter.

We ended the quarter with net debt of $135.3 million and net leverage of 0.75x EBITDA, which is down from 0.88x EBITDA at the end of our fiscal Q2 in November.

With respect to the Trax acquisition, we announced and closed the transaction yesterday. The consideration was $120 million in cash upfront, plus up to a $20 million earnout based on calendar year 2023 and 2024 adjusted revenue performance.

This represents a purchase multiple of 14x LTM EBITDA on the $120 million. Trax generated calendar year 2022 revenue of $25 million with approximately 35% EBITDA margins. We expect the acquisition to be immediately accretive to adjusted EPS, which will exclude the noncash amortization resulting from purchase accounting.

Note that the $20 million earnout consideration will be reflected in our SG&A over the 2-year period as there are retention conditions, but we will exclude it from our adjusted results. Based on the closing date, Trax will contribute a little more than 2 months to our fiscal Q4, we would expect it to contribute $3 million to $4 million in sales, with EBITDA margins around 35%.

Interest expense in the quarter will be impacted by the upfront $120 million at an interest rate of approximately 6%. As mentioned, we expect Trax to be accretive to adjusted EPS in FY '24. On a pro forma basis, our net leverage at the end of Q3 was 1.35x EBITDA, and our liquidity from remaining cash on hand and availability under our revolver was over $340 million.

As we have indicated previously, our priorities for capital deployment are in order, organic growth investments in our business, value-accretive inorganic investments to add complementary capabilities and capital return to shareholders.

Over the last couple of quarters, we have had attractive opportunities to deploy capital in the first 2 categories. As a result, we elected not to repurchase stock during Q3. We currently have $58 million remaining on the $150 million stock repurchase program that we announced in December of 2021.

We will evaluate usage of the remaining authorization over the balance of this calendar year, based upon alternative capital deployment opportunities. Thank you for your attention, and I'll 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, although macroeconomic uncertainty and concerns about the global banking industry are a watch item for all companies, we continue to be optimistic about the recovery in global flying and the resiliency of the aerospace aftermarket generally.

The demand outlook for international travel is particularly strong, and our commercial customers remain confident in their bookings. This is translating to continued strong demand in our hangers and for our commercial parts activities.

We expect continued growth in new parts distribution, which is benefiting both from recovery in demand and the ramp-up of recent contract wins. And in USM, we are seeing a loosening in the availability of supply. And as we mentioned last quarter, engine green time availability is decreasing, which should drive even more engine shop visits and associated USM demand.

In MRO, demand for heavy maintenance continues to be strong, and we expect to remain at near capacity for the foreseeable future. We continue to evaluate opportunities to expand our network, where we have customers, who have made commitments and confidence in long-term labor availability.

With respect to our government business, we continue to be well positioned to add additional short-term and long-term programmatic wins as a function of our best-value commercial best practices offerings. And we remain excited about the potential impact of the new NDAA language that facilitates the government's ability to act on more of our offerings.

Our Q3 results were driven by strong performance in both commercial and government markets. With respect to Q4, we expect continued growth in commercial, but expect a slight sequential decline in our government business. As such, overall in Q4, we expect similar to slightly better performance in total revenue and adjusted EPS relative to what we just delivered in Q3.

We expect growth to continue in our commercial business and growth to resume in our government business as we begin our FY '24. Speaking of FY '24, we plan to hold an Investor Day in New York City on July 20. More information will be forthcoming, and we look forward to providing more detail on strategy as we have done in the past.

Before opening it up to questions, I want to again express my excitement about the Trax acquisition. We have known the company and its management team for a decade, and I could not be more pleased that the opportunity finally emerged to join forces.

To reiterate what I said when I was with the Trax team yesterday in Miami, we see this as a unique opportunity to bring together AAR's hardware and Trax' software to support the global aerospace aftermarket in a way that has the potential to be extremely powerful over time.

I look forward to the great things that we can achieve together, and I welcome the highly successful Trax team to the AAR family.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Robert Spingarn with Melius Research.

Robert Michael Spingarn - *Melius Research LLC - MD*

Congrats, guys, on your acquisition. I want to start there, if I could. Can you talk a little bit about how Trax can grow differently, now that it's part of AAR versus whatever it's been doing in the past?

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

Yes, a great question. A couple of thoughts there. Trax is -- relative to some of the other players in the market, they're about the smallest just in terms of size, but they have a very broad market reach and have been among the most successful in the last several years in terms of market penetration.

One of the reasons that -- the main reason why they've been successful is just the strength of their product. They've got about the best product out there, and that's why they've been winning.

What's worked against them is just the fact that they've been a sole proprietorship essentially in Miami. And we believe that by combining with them, AAR as a much larger well-financed backer can help them open doors that they might not have otherwise been able to open. So that's one element.

Furthermore, AAR, just given our presence in the globe, our reach around the industry, we also think that we can introduce Trax to more customers that they may not have otherwise been able to reach already.

Robert Michael Spingarn - *Melius Research LLC - MD*

Is there a growth rate that we can talk about what they've been growing at and what you can do going forward?

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

Yeah. We can get more specific on that at a later time, but they have been growing very, very nicely. Again, we've been following the company for about 10 years and have seen their evolution in their platforms. .

For example, when we first started talking to them, not surprisingly, their software sat largely on mainframes and desktops. In other words, it was localized. They have replatformed. They have a whole suite of new offerings, new apps, if you will, and they're moving their users in the next generations to the cloud, and it's a SaaS-based offering.

So as that new offering takes hold and as they migrate current customers to the new platform, that has driven growth the last couple of years, and we expect it will drive continued growth in the next few years.

Robert Michael Spingarn - *Melius Research LLC - MD*

Okay. And then as an adjacent question, John, how can the Trax business drive your core legacy businesses? In other words, once you combine these two things, is it too optimistic to think it can drive more parts sales or more distribution, what have you?

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

I don't think that's optimistic at all. In fact, that's exactly how we're thinking about it. Ultimately, Trax is the system used by thousands and thousands of buyers and planners at airlines around the world. And this is a system that is used to actually make the purchase from AAR for our products and services that we offer.

And our plan is to basically bring more of our services closer to the customers and give customers around the world broader access to parts and parts availability.

Robert Michael Spingarn - *Melius Research LLC - MD*

Okay. And just a couple of other quick things. With this wide-body resurgence, how are you seeing that play out in your markets? And does it tempt you to get into more wide-body MRO?

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

From a -- we are seeing it certainly play out. From an MRO standpoint, we remain focused on our core offering around narrow-body. That's -- we've taken great steps over the last several years to really focus on that market, and that's where our strength is.

From a parts standpoint, though, particularly around engines, the power wide-bodies, that's an area that we are in today, predominantly in the cargo market.

But as we see more passenger aircraft take to the skies, we see opportunities to take the parts business to support that growth.

Robert Michael Spingarn - *Melius Research LLC - MD*

Okay. And then just the only other thing I wanted to ask you, John, is you talked about the USM strength and recent investments. And I just want to understand better where we are in this USM cycle. I would have thought that a lot of whatever materials out there on parked aircraft, et cetera, might have been depleted by now. So if you could just update us on what's happening.

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

I think you're correct in terms of material out of parked aircraft, but we haven't seen the elevated levels of retirements that have been forecasted for many years, particularly at the beginning of the pandemic.

As OEM production rates come up and as airlines re-fleet their aircraft, we do expect to see more retirements over time. Although that dramatic jump that many talked about for so long, we don't expect that. But we do expect that curve to steepen over the next few years, and that will provide more material for our USM business.

Operator

Our next question comes from the line of Josh Sullivan with Benchmark Company.

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

Well, just on the government services side, what does the recompete outlook, like over the next 12 months or so?

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

For existing programs that we're on, off the top of my head, I don't -- I'm not aware of any major recompetes for programs that we are currently on. However, there are a number of recompetes in process right now for programs that we are not on, and we are a bidder on those programs. To the extent we're successful, that would be a net new work for AAR.

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

And can you just expand on the comment about the NDAA language that allows more access to air services?

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

Yes. We talked a little bit about that last quarter. And ultimately, when ended up in the most recent version of the NDAA that was passed, was language that requires branches of the DoD to consider buying used parts anytime they go to the market.

And so our used parts offering, which, as you know, has been very successful in the commercial market, now as agencies as they look to buy parts, are required to give that a look.

And we expect over time as these agencies become more educated on the benefits of buying USM, that could be a growth market for us.

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

And then are there any opportunities for Trax in the government sector?

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

That's a great question. Yes, we believe so. They do a little bit of work in the government area already. As a matter of fact, the FAA itself -- is actually attracts customer. But we believe, again, similar to the commercial market, there are doors in government agencies. But because of our presence, we can help open for Trax.

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

And then on the distribution on the commercial side, availability look like coming from the OEMs. Any supply chains getting better? Just any comments on what you're seeing there.

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

I'd say, it's stable. It's been stable over the last few quarters. And when we think about supply chain for our business, certainly availability of labor, we kind of put in the supply chain bucket. But as it relates to parts availability from the OEMs and repair turnaround times, both of those elements have stabilized in the last few quarters. .

Lead times still are longer, for the most part, than they were pre-pandemic. So we just adjusted our buying patterns to account for that. And similarly, as we manage parts in the USM business that we send out for repair, we've accounted for longer turnaround times as we look to buy and market material.

Operator

Our next question comes from the line of Michael Ciarmoli with Truist.

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

John, just on the -- into the fourth quarter, I mean it's usually, seasonally, your strongest quarter, but I think you called for flattish revenues.

I mean is this just still the dynamic of coming off the COVID recovery? Or is there any reason why we shouldn't think kind of the airlines prepping for the summer flying season wouldn't be as strong as kind of pre-COVID conditions? Or just what's kind of going on with the dynamic there?

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

Yes, really two elements in both commercial and government. In commercial, we do for all the reasons you just mentioned, we expect continued growth sequentially in Q4. The parts businesses remain strong, MRO remains strong, and we expect continued growth in commercial in Q4. What's partially offsetting that is the government side.

We've mentioned this a few quarters ago. As we saw the wind-down of certain long-term government contracts, we have been able to offset a fair bit of that wind-down with shorter-term government activities. We were successful in doing that in Q3, which accounted for the strong government program performance in Q3.

However, we don't expect that same level of activity on the government side in Q4, which net-net leads us to a, I would say, similar to slightly better overall Q4 in revenue and EPS than what we delivered in Q3.

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

Okay. Okay. Can you elaborate on what that short-term activity is? I mean, is that just picking up ad hoc, logistics, repair work? Or maybe you can elaborate kind of what you're doing there?

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

Some of it is the tempo in individual programs that we see, and other of it is more transactional parts of activity with the government.

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

Got it. Okay. And then just back to Trax. I mean just having that asset in-house you're mentioning all the customers, all the aircraft, does this gives you better intelligence on what type of material might be in higher demand? Does it give you a little bit of an advantage in terms of buying USM or feedstock that's out there?

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

Ultimately, Trax manages a tremendous amount of data for its customer base, and that is Trax data and owned by Trax customers. Over time, we want to work with Trax and their customers, many of whom are our customers, to see how, in partnership with everybody, we might be able to use that to offer more parts and solutions, more parts availability to the Trax customer base. .

So yes, over time, we believe that will be an accelerant to our traditional businesses.

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

Got it. Okay. And then just the last one. On the JV with Fortress, I mean they're out there kind of they're telling a pretty good story. I mean they're obviously going after the CFM56s. But are they going to be -- I guess I'm trying to think about the dynamic of you guys trying to -- you have access to some of that engine material, but it sounds like they also are focused on ramping up their USM.

I mean, is that contract in that JV playing out as expected? Or are there any sort of competitive dynamics there in terms of going after similar material? Or just maybe a little bit more color on kind of the workings of that relationship.

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

Yes. Good question. So the JV that we have with them and the overall relationship is going as well, if not better, than we expected when we originally outlined it. .

I think possibly what you're hearing there is just different activity on different platforms. So the platforms in which we're covering with Fortress, there's a lot of respect and again, a lot of good momentum around that relationship. Fortress has got a broad engine portfolio, and they're talking about other areas, not the areas where we're in partnership with them.

Operator

Our next question comes from the line of Ken Herbert with RBC.

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

John and Sean, this is actually Steve Strackhouse on for Ken Herbert. Congrats on the strong quarter. Just a couple of quick questions, starting with Trax. How are you thinking about the cost synergy capture with that opportunity? And then, now that you've acquired Trax, what is your view on maybe further M&A that you might be looking at for FY '24?

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

Great. Thanks. Appreciate the question. First, with respect to Trax, we are not really focused on cost synergy at this point. This is really a growth play. As we mentioned earlier, we believe that we can help grow Trax' revenues by funding further development of their products and services and by opening doors for them around the world with a larger customer base, government included.

So we really view this, from a synergy perspective, around growing revenues of Trax. And then similarly, on AAR side, again, over time, as we develop Trax and work in cooperation with their customers, we think this could be a unique channel to market for our traditional products and services, which would in turn grow our own revenue. So really, it's a revenue synergy play with Trax.

And then thinking about M&A, as you heard from Sean, we think about capital deployment first, organically; second, inorganically, M&A; and then third, returning capital to shareholders.

We are very encouraged right now by the pipeline of M&A opportunities that we see. We have been following many assets for many, many years. Trax is an outstanding example of that. We've been working with them and thinking about this deal for really about 10 years, and it's great to get it over the finish line.

There are other companies out there that we expect to come to market here in the next -- in the medium term. And with the balance sheet strength that we have, provided that it fits the portfolio and the value makes sense, we're in a great position to act.

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

Awesome. And then maybe just one follow-up from there. You touched a little bit on USM both in the prepared remarks and a few of the questions. But as you look at some of the asset acquisitions, where are you seeing some of the buying opportunity? Is it with engines, maybe airframes? And how is that pricing trending for the available feedstock? .

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

I would say, first part, we are seeing it in both categories, individuals on their own as well as whole airframes that come with engines. And so we have seen more packages come available in the last couple of quarters. And we expect to see more material come on the market. And again, we're in a very strong position to act on that.

With respect to pricing, I wouldn't want to comment on that element just for competitive concerns, but we are encouraged by the assets that we see coming available.

Operator

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*

That's great. Thank you very much, everyone, for your time and attention, and we look forward to talking to you next quarter. Thank you.

Operator

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