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AIR.N - Q1 2024 AAR Corp Earnings Call

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## 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*

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

**Robert Michael Spingarn** *Melius Research LLC - MD*

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

## PRESENTATION

**Operator**

Good afternoon, everyone, and welcome to AAR's fiscal 2024 First 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 and the Risk Factors section of the company's annual report on Form 10-K for the fiscal year ended May 31, 2023.

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.

A replay of this conference call will be available for on-demand listening shortly after the completion of the call on AAR's website.

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

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

Thank you, and good afternoon, everyone. I appreciate you joining us today to discuss our first quarter fiscal year 2024 results. This was a very strong start to the year, and I am both encouraged by our sustained momentum and proud of our team for continuing to deliver.

Specifically, sales for the quarter were up 23% year-over-year from $446 million to $550 million. Sales to commercial customers increased 34% and sales to government customers increased 3%. Within Parts Supply, sales were up 40% over the prior year quarter as we monetized USM investments that we made over the last year and as recent distribution wins continue to mature.

Regarding USM, even though supply remains tight, our global sourcing team continues to secure high demand material. New parts distribution saw continued growth in our commercial product line, which more than offset lower parts sales to the U.S. government.

In Repair & Engineering, sales were up 8% over the prior year quarter, driven by continued strength in our hangars, partially offset by a slowdown in our landing gear operation due to the repair cycle timing of certain gear types. In Integrated Solutions, sales were up 22% over the prior year quarter due to increased flight hours in our power-by-the-hour programs, the contribution from Trax and the strength in our government programs.

Notably, our F-16 program in Europe is still in the process of ramping up and will become a more meaningful contributor as the year progresses.

Turning to profitability. Our adjusted operating margin was 7.3%, up from 6.9% in the prior year quarter. Adjusted operating margins expanded in all of our segments, except Expeditionary, and this represents our tenth consecutive quarter of year-over-year adjusted operating margin expansion.

Our adjusted diluted earnings per share from continuing operations were up 28% from $0.61 per share to a first quarter record of $0.78 per share. With respect to cash, as we indicated in last quarter's call, we saw attractive opportunities to invest in our Parts Supply segment in the quarter, which drove a use of cash in operating activities from continuing operations of $18.5 million.

Specifically, we made a net inventory investment of $38 million in our Parts Supply segment to support both USM demand and our recent distribution wins. It is worth noting that our prior Parts Supply investments are what drove the growth in profitability in this quarter, and we expect strong results from these most recent investments over time as well.

Even after these growth investments, our net leverage at quarter end was only 1.18x adjusted EBITDA, and as such, our balance sheet remains exceptionally strong. Before I discuss the business, I would like to comment on the recent news regarding a parts supplier that allegedly provided uncertified parts using forged paperwork for use in CFM engine repairs. AAR neither purchased or sold any parts from this supplier.

Since our founding nearly 70 years ago, we have been exceptionally focused on quality and safety and conduct the highest level of diligence when we source parts. This incident highlights the value of our quality systems, and we believe it will result in customers placing even greater emphasis on AAR's reputation for doing it right.

Now turning to new business. During the quarter, we announced 2 multiyear commercial agreements with Moog, 1 for distribution and 1 for reciprocal component repair services. Importantly, these agreements are first steps in a new strategic relationship with Moog that we expect will lead to new opportunities.

In addition, subsequent to the quarter, we announced an exclusive multiyear agreement with Pall Corporation, a Danaher company, to distribute highly engineered filtration products to foreign military customers. This agreement recognizes the extended customer reach that AAR provides to our partners as well as the investments that we have made in recent years to augment our foreign military sales capability and our compliance programs.

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

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

Thanks, John. Our sales in the quarter of $549.7 million were up 23.2% year-over-year. Our commercial sales were up 33.7%, driven by growth across our commercial activities, particularly Parts Supply. And our government sales were up 2.9% due primarily to Integrated Solutions, partially offset by declines for new parts distribution in Parts Supply and Expeditionary.

Gross profit margin in the quarter was 18.4%, consistent with the prior year quarter on a reported basis and up from 18.1% in the prior year quarter on an adjusted basis. Gross profit margin in our commercial business was 19.3% and gross profit margin in our government business was 16.3%.

SG&A expenses in the quarter were $74.7 million, which included the $11.2 million charge we announced last week associated with the Russian court judgment and $2.8 million from Trax acquisition and amortization expenses as well as increased investments in the business.

In the Russian judgment, a court directed us to make a payment equal to the alleged fair value of aircraft engines we purchased from a Russian airline in 2016 and 2017. We strongly disagree with the Russian court judgment. And as noted in our September 22 8-K, I believe the judgment is a result of, among other things, a hostile business and legal environment for foreign companies in Russia.

Additionally, we believe we have strong defenses to any attempt that may be made to recognize and enforce the adverse judgment. Excluding this charge, the Trax expenses and $1.1 million of compliance costs, SG&A was $59.6 million or 10.8% of sales.

As we announced last month, we entered into an agreement during the quarter to effectively transfer our pension obligations and assets to an insurance company. This transaction allowed us to fully secure the funding for planned participants and eliminate our planned management activities and associated funding risk going forward. Due to the plan's funding status, no additional contributions were required as part of the transfer. And in fact, there was a surplus funding of $7.6 million, which we expect to use to fund certain 401(k) contributions.

In conjunction with this transaction, we recognized a noncash pretax pension settlement charge of $27 million in the quarter. We are very proud to be able to deliver on the commitments made to plan participants and have concluded our activities associated with the U.S. pension plan.

Net interest expense for the quarter was $5.4 million compared to $1 million last year, driven by higher interest rates and borrowings. Regarding our effective tax rate, we expect it to be approximately 27% for the balance of the year. Cash flow used in operating activities from continuing operations was $18.5 million.

As John indicated, this usage was driven by net inventory investment of $37.9 million in our Parts Supply segment to support both USM and new parts distribution demand. Specifically, these investments included a variety of engine platforms for USM material and inventory to support certain recently awarded distribution lines. We expect these investments to continue to generate a strong return on invested capital going forward.

Even after the investments, our net leverage remains low at 1.18x adjusted EBITDA. We are continuing to see both robust demand for aftermarket parts and attractive opportunities for further investments in Parts Supply. That said, we expect to generate slightly positive cash flow from operating activities in the second quarter.

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

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

Great. Thank you, Sean. Over the last few years, we've been proud of our ability to operate successfully in a particularly dynamic environment, and the environment certainly remains dynamic today.

While we expect the global aviation industry and our major customers to continue to grow, some low-cost and regional carriers have cited a slowing of demand and fuel prices and inflation remain watch items for the industry. At the same time, new aircraft delivery constraints and the ongoing GTF issues mean that the current fleet will continue to operate longer, which overall directly benefits the AAR. Therefore, on balance, we expect continued strong demand for our parts and services.

For our parts activities, while USM supply remains constrained due to the factors I just mentioned, we're still seeing attractive opportunities to invest, and we expect that over time as new aircraft and engines are ultimately delivered the availability of USM supply will gradually improve.

In Repair & Engineering, our hangars are expected to remain largely full for the foreseeable future. Our Miami hangar expansion is progressing, and we continue to evaluate expansion at other hangars where we can partner with local governments, leverage existing overhead, expand our customer commitments and readily access labor.

On the government side, as you know, there is a possibility of a shutdown. If that occurs, our current expectation is that it would not significantly impact our Integrated Solutions business given we operate under previously awarded contracts. It may have some impact on our government distribution operations in terms of payment timing, orders and shipments. In any event, the situation is fluid, and we plan to remain flexible so that we can take action as needed to mitigate any impact.

All that said, in general, we see a constrained budgetary environment as supportive of our efficient commercial best practices offering to our government customers. Looking forward, with respect to Q2 overall, assuming no extended government shutdown, we expect both year-over-year and sequential sales and earnings growth. Specifically, we anticipate mid- to high teens year-over-year sales growth with operating margins similar to or better than what we delivered in Q2 of last year.

More generally, we are encouraged by the demand signals we are receiving from our primary customers and this, combined with the industry's continued reliance on current generation aircraft creates a very favorable operating environment. In our government business as we win new contracts and the focus shift to fleet readiness, we expect to accelerate our growth trajectory.

Again, we are encouraged by our very strong start to the year and look forward to continuing to invest in our business and our people to drive further growth.

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

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## QUESTIONS AND ANSWERS

**Operator**

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

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**Robert Michael Spingarn** - *Melius Research LLC - MD*

I wanted to ask you about your very good sales growth in the quarter and what you just talked about for next quarter, and how we think about that against the 5% to 10% CAGR you're looking toward over the next few years? And maybe as a subcomponent to that, John, does any of this GTF situation? How does that translate for you guys?

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

Sure. Thanks, Rob. All good questions as usual. So as it relates to the quarter, obviously, as you can tell, we're really proud of what we delivered, it's really strong growth across the company, most notably in the parts business.

And how that relates to the 5% to 7% guidance that we put out, obviously, that's a multiyear target -- and as we continue to ramp up, the comps year-over-year will continue to increase. So we're thinking about years ahead.

But in the immediate term, as we indicated for Q2 and the rest of this year in particular, we expect to be above that long-range target.

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**Robert Michael Spingarn** - *Melius Research LLC - MD*

(inaudible)

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

Yes. And on the GTF, I would say, anything right now that takes next-gen aircraft out of service and places more emphasis on the current generation of aircraft is a positive for us. So if you've got 600 or more aircraft that are going to be coming out for these mods over the next couple of years, that's just going to put more pressure on the existing fleet, which is our bread and butter right now.

So net-net, that will likely be a positive for us. The flip side is it's going to continue to constrain the supply for USM material. But as we've demonstrated last year and this year with some of the investments we've been able to find and make, we're still -- we believe, doing a good job of going out there and finding material to support this great growth even when the supply is tight.

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**Robert Michael Spingarn** - *Melius Research LLC - MD*

Okay. Super helpful. I wanted to ask you on distribution. When we think about -- you're adding contracts -- and you've been very clear that they take a couple of years to ramp. So we should expect more sales contribution from these latest ones over time.

How should we think about the margins in this business. KLX was in the mid-teens before it was acquired by Boeing. On the other hand, other distributors have been a bit lower. I'm thinking of Aviall. What's the right way to think about margins in this business?

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

Yes. We'd be probably somewhere in the middle. The margins for that business are higher than the overall margin for the company right now. So as that business continues to grow, that mix shift will be favorable -- that's part of the reason you've seen the continued improvement in operating margin over the last 10 consecutive quarters.

And as we've talked about, we -- because of our market position as the largest independent and our balance sheet to continue to go ahead and invest in these programs, whereas our larger competitors owned by Airbus and Boeing, don't have the independence or the focus on this type of investment. We think it's a great opportunity for us to just continue to take share.

And as that mix shift continues to head towards parts in general, but most specifically distribution, that will be accretive to operating margins.

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**Robert Michael Spingarn** - *Melius Research LLC - MD*

Okay. Fantastic. Just a quick one. Maybe this is -- Sean, this is for you. But the margins in the quarter were a little bit softer than the prior quarter, and I think you've been calling for them to be about the same, is there anything behind that?

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

Yes. And I think as you take a look at some of the segment detail that's in the release as well as the Q that will come out. I think margin is still really strong performance, significant improvement from the prior year period. But as you mentioned, sequentially a slight decline, and a lot of that came in parts, which was relatively consistent with the prior year quarter, which is down slightly.

That's just a mix of a really strong Q4 that finished last fiscal year and then what we saw in this quarter.

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**Operator**

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

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

Nice results. Maybe just back to Rob's question. Just looking into second quarter guidance, I think you said mid- to high teens year-over-year. I don't think you said anything sequentially. I know first quarter is usually seasonally weaker, but it kind of implies maybe sequentially flattish or just up slightly. I mean is it just -- can you give any more color on maybe how we should think about 2Q and seasonal trends if they were as present this quarter as normally?

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

Sure. Great question. We would expect up slightly sequentially. And as it relates to seasonality, we've seen this now coming out of COVID where, if you recall, pre-COVID, we definitely would see a pretty meaningful drop from Q4 to Q1. We obviously did not see that this quarter, and we're very proud of that.

And it had been less severe last year than it had been in prior years. And the reason for that is we've really worked with our customer base in the hangars to level load the operation. And we've also continued to refine the number of customers that we work with in our hangars.

But the airlines, even though they want their aircraft as much as possible to be in the air during the summer, they recognize that to keep work going, to keep the workforce around given the labor supply constraints, it's best for everybody. And so we do expect continued slight seasonality going forward, but not to the degree that we would have seen prior due to the changes I just mentioned.

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

Got it. Got it. That's helpful. And then maybe, John, just -- I think you mentioned a slowdown in landing gear. Can you maybe elaborate on that comment a bit? I don't think I caught it at all.

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

Yes. Yes. Gear are on a -- and obviously, our MRO business, it's hangars, which we pay a lot of attention to is component, repair and it's landing gear. Those are the 3 main activities, obviously dominated by hangar, but those other 2 are meaningful as well.

The landing gear business is on roughly a 10-year cycle and gear come off at intervals over their lifetime for overhaul. And we are coming kind of on the other end of what had been a pretty significant overhaul cycle for the customers that we serve. So that business is forecasted is in a bit of a decline right now just based on the natural cycle for these overhauls.

That will last for a period of time, and then it will pick back up, but that was obviously some slight softness inside of Repair & Engineering that we wanted the highlight.

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

Got it. Okay. And then last 1 for me, and I'll jump off here. Just I guess if you go out there and look for some of that new material in the Parts Supply, the USM, what are you seeing in terms of profitability?

And I guess, maybe that kind of leads into what is the market looking like? I mean is it pretty active to get your hands on that material? Are you having to pay higher prices than normal? Can you kind of protect your kind of historical returns, if you would? Or maybe just any color there?

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

Yes. Great question. So I would say, yes, we absolutely for the asset types in which we're mostly active are paying higher prices, but we were also able to charge higher prices. So we are able to maintain our spread.

You're going to see some fluctuation as you did in this quarter in any 1 quarter just based on the mix of assets that we sell, whether they're whole engines or parts, et cetera, it will move margins around a little bit.

But generally speaking, the spread that we've had for years, we're able to maintain it, if not grow. And once again, I just want to highlight the efforts of the team there. It is a really tight market. We're the largest in the world in terms of going out there and sourcing material. And that's 1 of the reasons that we're so focused on maintaining balance sheet flexibility to the extent that we have the opportunity to deploy some capital to get our hands on some great materials as we did this quarter, for example, that we're in a position to do that.

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**Operator**

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

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

John and Sean, congrats on the nice sales growth in the quarter. This is Steve Strackhouse on for Ken Herbert. First wanted to just talk about the pricing in the aftermarket and what you guys are kind of seeing there? I assume it's going to be some strong pricing. So maybe if you could just kind of walk us through that.

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

Yes. I think similar to what I just mentioned, we are absolutely able to command strong pricing in the aftermarket but also particularly in the used parts business, we're having to pay higher prices because material is in such demand.

We haven't talked much about pricing in the hangars. And as you know, the last couple of years, we've seen a pretty meaningful rise in our labor costs, but we've received great support and cooperation from our MRO customer base about making pricing adjustments oftentimes off-cycle from contract renewal periods in order to make sure that we can maintain our profitability to continue to provide them great support.

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

Sounds good. And maybe just 1 more for me. I think at the Investor Day, you had talked about the maturity cycle being very robust on something like the CFM56, V25. With regard to some of those engines and the issues at Pratt for your turbofan. Just how do you think about shop visits in that going forward?

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

Yes. We remain very bullish on that. The engine shop -- and you're bringing up a great point. We sell parts to airlines, but some of our biggest parts, our biggest customers in the parts business are the engine shop themselves.

And we received forecast based on their expected inputs over a year or longer, and they are all very full for those engine types that you mentioned. And so we expect a strong demand there for some time to come.

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**Operator**

Next question comes from the line of Josh Sullivan with Benchmark.

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

On the forged parts issue that's percolating through the industry here, is that -- can that be a driver for Trax? Or is there a way to leverage the Trax franchise for that?

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

Yes, that's a great question. It's something we've been talking about even before this, that being able to track the providence of parts digitally and some people talk about blockchain or other elements to do that is definitely something that we think the industry can benefit from.

And unfortunately, this fraud that's out there is highlighting that need. To do those things take some time -- and I would say it's currently not part of the Trax platform. But given the technological capability that we acquired with that company, this is definitely something that we could pursue. So the short answer to your question is, yes, I think that could be part of the longer-term solution here. And if we think there's a market for Trax, we've got the capability to make investments and go in that direction.

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

Got it. And then a question on labor, given the demand that's going to be out there for wrench turners to address some of the RTX issues. Are you seeing any pressure on labor rates at this point?

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

It's been stable. We've seen it, as I mentioned for the last couple of years, but it's not at the accelerating rate that it had been before. Now we're certainly aware that as the airlines look to continue to negotiate their contracts with unions, et cetera.

Obviously, we've been focused on pilots to the extent that they move on to mechanics and other constituencies that, that could create a downstream effect to our nonunion team but it would be the same dynamic that we've been dealing with for the last few years, which is to the extent that we've seen increase in our cost, we need to seek relief from our customers so that we can continue to provide the service that they've come to rely on.

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**Operator**

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

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

Great. Well, we really appreciate everybody's time and interest, and we look forward to being back here for the Q2 earnings call. Thank you.

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**Operator**

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

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