

Time to buy revamped CAE?

Flight simulator maker has changed direction

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Bay Street breathed a sigh of relief when Robert Brown, the chief executive of CAE Inc., announced earlier this year that he was implementing a dramatic overhaul at the troubled company, which develops and manufactures high-tech flight simulators for commercial airlines and the military.

The move to cut 450 jobs, close training centres and scale back production capacity was, in Mr. Brown's words, necessary to transform CAE from a company that spent all its time obsessing about the latest software innovations to one that is focused on making money and delivering what its customers want.

Analysts said the long-overdue changes couldn't have come at a better time, with commercial aviation on an upswing as travellers put the haunting memories of 9/11 and SARS behind them.

Which raises the question: Is now the time for investors to climb aboard CAE's turnaround?

At the moment, most of the Street is saying "no" based on current valuations, although there are several who are slightly more optimistic, albeit for reasons that are harder to quantify.

"I think they are doing all the right things and I think they are well-situated given their technology," said Ted Larkin, an analyst at Orion Securities, who has a "sector underperform" rating on CAE's shares (CAE/TSX).

"But I believe that they have a number of low-margin contracts still embedded in their backlog. And its going to take them awhile to chew through those.

"The stock, meanwhile, has moved ahead very sharply and has taken into account a lot of the good news that's going to be coming in six to nine months time."

CAE's shares are up 20% since February -- closing at \$5.90 yesterday. However, CAE's reputation as a perennial disappointment -- the company has a miserable history of missing earnings targets and botching financings -- may also be colouring the Street's thinking, creating an "I'll-believe-it-when-I see-it" mentality.'

Mr. Larkin, for one, is urging investors to buy CAE shares only if they dip.

Similarly, Cameron Doerksen, an analyst with Versant Partners Inc., said the full benefits of CAE's restructuring won't be apparent until 2007, and that the current share price already reflects "much of the positive long-term outlook."

Mr. Brown himself has warned that CAE would be hard-pressed to break even over the next 12 months, saying "This is going to be a transition year."

But there have already been small surprises. In May, CAE beat analysts' estimates by posting fourth-quarter earnings of \$14.1-million, compared to \$16.1-million last year.

Such performances have added fuel to the arguments of those who say that a buy-onweakness strategy will backfire.

"The most difficult thing to know is when to invest in a turnaround," says **Anthony Scilipoti** at **Veritas Investment Research**. "But at this point, I say the balance sheet is in order, so what's my downside? The stock goes back to \$5? I can live with that."

Colouring **Mr. Scilipoti's** thinking is his belief that CAE has hit rock-bottom in terms of the money it makes on each flight simulator. Even if market conditions fail to improve, CAE will still improve its performance simply by shutting down some operations and trimming excess capacity, he says.

Last fiscal year, CAE lost \$200-million on a 5% increase in sales to \$986.2-million. That included a goodwill charge of \$443-million and a \$25-million worth of restructuring charges. Meantime, the company managed to cut its long-term debt to \$286-million from \$530-million a year ago.

Jacques Kavafian, an analyst at Research Capital, also sees an opportunity in CAE, but offers a slightly different rationale behind his "buy" rating. "The business model employed by CAE provides downside protection, while giving an unlimited upside," he argued in a research note yesterday.

The downside protection comes from CAE's pilot training division. The division has 15% of the market, and commercial airline pilots are required to spend a predetermined amount of time in a simulator every six months to keep their licenses current.

The upside stems from recent growth in global airline traffic, which, in combination with high fuel prices, has caused airlines to consider upgrading and streamlining their fleets in order to save money on maintenance and fuel costs.

At the same time, argues Mr. Kavafian, airlines are looking to save money on pilot training, opting for cheaper simulators that aren't burdened with unnecessary technology -- a charge that has been leveled at CAE's previous products.

Mr. Brown, who replaced former CEO Derek Burney last year, has promised to do a better job at making products that customers want.

It's also worth noting that CAE's military division, which accounted for 45% of revenues, shows no signs that it's poised for a downturn.

Investors may also want to consider the motivations of Mr. Brown -- something that is hard for analysts to incorporate into their models.

So far, he has shown a willingness to make hard restructuring decisions, something that his predecessor couldn't or wouldn't do. As well, several have noted that he is now now kneedeep in his second recent restructuring effort. Mr. Brown left Bombardier three years after his plans for the struggling aerospace firm ran afoul of some of the company's controlling shareholders.

"Robert Brown has something to prove here," said **Veritas' Mr. Scilipoti**. "He's coming away from a disaster at Bombardier. I think he wants to leave a mark."