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PRESENTATION

Operator

Good Day, and thank you for standing by. Welcome to the AAR Corp. Fourth Quarter 2022 Earnings Conference Call. (Operator Instructions) Please be advised that today's conference is being recorded.

I would now like to hand the conference over to AAR. Please go ahead.

Unidentified Company Representative

Thank you. Good morning, ladies and gentlemen, and welcome to AAR's Fiscal '22 Fourth Quarter Earnings Call. We're 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, 2021, and Form 10-Q for the fiscal quarter ended February 28, 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'd like to turn the call over to AAR's President and CEO, John Holmes.

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

Thank you, and good morning, everyone. I appreciate you joining us today to discuss our fourth quarter and full year fiscal 2022 results. Before I comment on the results, I would like to take a moment to reflect on the last fiscal year. We entered the year with optimism that the increasing demand for domestic leisure travel we saw in early summer last year would be a leading indicator for business and international travel.

Shortly thereafter, the Delta and Omicron variants emerged and those markets did not rebound at nearly the same rate. In addition, the U.S. withdrawal from Afghanistan as well as the natural conclusion of certain of other of our government programs, created headwinds in our government business, which had been an important source of strength during the pandemic.

Finally, in the macro environment, labor has been in short supply, inflation has been running high, and there is uncertainty about economic growth. In light of this backdrop, I'm incredibly proud of the results that we delivered this year. It was not inevitable that AAR would be able to navigate the pandemic in the way that we have. And that's a credit to our team for finding a way and to our customers for recognizing the value that we deliver and I want to thank them both.

Turning to the results for the full year. Sales increased 10% from $1.65 billion to $1.8 billion and adjusted diluted earnings per share from continuing operations increased 82% from $1.31 per share to $2.38 per share.

We were able to more than offset a 13% decline in sales to the government customers with a 34% increase in sales to commercial customers. Even more importantly, we were able to continue to drive efficiency improvements and cost discipline to deliver significant earnings growth.

For the quarter, sales were up 9% from $438 million to $476 million and adjusted diluted earnings per share from continuing operations were up 53% from $0.47 per share to $0.72 per share. Our sales to commercial customers increased 28% and our sales to government and defense customers decreased 13%.

Sequentially, our total sales growth was 5% and our adjusted EPS growth of 14%. Our operating margin was 7% for the quarter on an adjusted basis, up from 5.2% last year and 6.7% in the third quarter.

We continue to see strong performance in our MRO operations as our hangers remain nearly full, and we continue to benefit from the efficiency initiatives that we implemented across the company during the pandemic.

In our parts activities, we saw further recovery in the quarter but demand remains inconsistent and the availability of used serviceable material to support our trading operations remains in short supply for certain platforms.

Turning to our government business. While we saw a decrease in revenue, it is important to note that despite this decline, we were able to expand margins during the quarter.

Just taking a step back, I would like to highlight that in this quarter, we delivered adjusted operating margin and EPS that exceeded pre-COVID levels, despite our sales being down 15% from their pre-COVID high. This was a goal we established early in the pandemic, and I'm proud of the work we've done to deliver against that commitment.

Regarding cash flow, it was another strong quarter as we generated $40.2 million from operating activities from continuing operations. We also repurchased $22 million of stock in the quarter under our share repurchase program. Even after the share repurchase, we reduced our net debt leverage to 0.3x EBITDA, and we continue to be exceptionally well positioned to fund our growth.

Turning to new business. During the quarter, we announced a marketing partnership with ProvenAir Technologies which has developed a digital solution that uses proprietary algorithms to analyze and dynamically generate back-to-birth trace history for aircraft parts. This is a capability that we are using in our own operations and this partnership allows us to bring this emerging digital solution to our customers as well.

In addition, we announced our relationship with Aero Design Labs, which is a company that has developed an aerodynamic drag reduction system kit for the 737NG. This kit has the potential to reduce fuel burn by 1.5% for the 737-700, which equates to over 40 tons of CO_2 reduction per aircraft per month and the benefits are expected to be even larger of the 737-800 and 737-900. We will be providing distribution services to the company on an exclusive basis and have also invested in the company to help fund its growth.

Finally, earlier this week, we announced that we became the first non-OEM to be awarded the Captains of Industry contract by the Defense Logistics Agency.

This is a distinction that establishes a long-term strategic supply chain relationship with the U.S. Department of Defense and will provide us with access to unique opportunities to support the U.S. and its allies.

With that, I'll turn the call over to our CFO, Sean Gillen, to result -- to give us results in more detail.

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

Thanks, John. Our sales in the quarter of $476.1 million were up 8.8% or $38.5 million year-over-year. Sales in our Aviation Services segment were up 9%, driven by the recovery in our commercial business, and sales in our Expeditionary Services segment were up 4.5%.

Overall, our commercial sales were up 28% year-over-year, while our government sales were down 13%, driven by the wind down of our activity in Afghanistan and the natural completion of other government programs. Sequentially, our commercial sales increased 11%, and our government sales decreased 3%.

Gross profit margin in the quarter was 18.9% versus 16.4% in the prior year quarter, and adjusted gross profit margin was 18.6% versus 16.5% in the prior year quarter. Gross profit margin in our commercial business was 17.7% and gross profit margin in our government business was 20.8%. The government margin was driven by continued strong performance as well as certain contract modifications, which resulted in higher recovery on indirect costs.

SG&A expenses in the quarter were $56.9 million. This figure includes increased investments in our digital initiatives as well as $2.9 million related to investigation and remediation matters and strategic project costs.

As a reminder, our fourth quarter has historically been our seasonally highest SG&A quarter, and we remain committed to driving SG&A down as a percentage of sales while continuing to invest in our growth.

Net interest expense for the quarter was $0.6 million compared to $0.9 million last year, driven by lower borrowings despite the increase in interest rates.

As John indicated, we generated cash flow from our operating activities from continuing operations of $40.2 million. In addition, we funded $22.2 million of share repurchase and reduced our accounts receivable financing program by $3 million.

Our balance sheet remains exceptionally strong with net debt of $46.5 million and net leverage of only 0.3x. Consistent with the last 2 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.

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. Looking forward, while demand for domestic and European commercial travel continues to be very strong, global traffic recovery in total continues to be slower, and we are paying attention to the macroeconomic environment and its potential impact on the market for air travel.

For us, commercial parts demand should generally track the recovery in commercial flying. Within commercial parts activities, the growth of our used parts sales will also be impacted by the availability of supply, which remains tight for certain platforms while the growth in our new part sales should continue to benefit from the new distributorships we have won recently and those that remain in our pipeline.

Demand for MRO remains strong, and we expect the hangers to remain largely full throughout this fiscal year.

In our government business in the coming quarters, we expect growth to return as recent program wins ramp up and as we convert opportunities from our strong pipeline.

With respect to Q1 specifically, as you know, historically, Q1 has been a down quarter sequentially from Q4, and we expect that to be the case this year. We also expect to make investments in our business in the near term as we prepare for additional commercial parts demand as well as to potentially fund inorganic growth.

For full year FY '23, given that the trajectory of the commercial aviation market recovery remains difficult to predict, exacerbated by increasing macroeconomic uncertainty, we are going to continue our recent practice of not providing formal guidance. Having said that, based on what we can see today, we expect sequential quarterly growth to return beginning in Q2, and we will continue to provide updates as we move through the year.

Over the longer term, we remain exceptionally well positioned. Our unique independent Aviation Services business model continues to resonate with both commercial and government customers. Our end markets are growing, and we have the balance sheet strength to fund our continued expansion. I'm excited about all of the opportunities we have ahead of us, and the team and I remain committed to delivering value for our shareholders.

Before we take questions, I want to take a few moments to recognize our Chairman, David Storch. We announced yesterday that David has chosen to retire from the Board effective in January. David started at AAR in 1978 and served as its CEO from 1996 until 2018.

During that time, he more than quadrupled the company's sales while navigating numerous peaks and valleys in the aviation industry, including both 9/11 and the great financial crisis. Even more importantly, he established and modeled the doing-it-right approach, which is the culture we continue to live by, and set the foundation for the company to be the pillar of strength and opportunity than it is today.

I congratulate David on his retirement and thank him for his leadership, counsel and friendship.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Ken Herbert with RBC.

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

John, I appreciate the commentary on sort of the full year '23 outlook and, I guess, lack of visibility. But can you help at all or provide any more granularity on the commercial business? You said MRO is largely full. So it sounds like that business is maybe flat to up slightly, but what's the growth expectation specifically on the parts side in fiscal '23, if you could provide any more detail around that?

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

Yes. You've got it right on the MRO side. From what we see today, the hangers are largely full, and we expect continued strong demand throughout the year in heavy maintenance.

On the parts side, the distribution business, the commercial distribution business, continues to grow, and that's largely driven by the new wins that we've announced in the last 18 months as they come online.

So we expect growth in the new business, in the new parts business as a result of those wins. In the used parts business, it's more of an inconsistent story. We saw quite a bit of accelerated demand through Q3 as well as through most of Q4. That demand has moderated a bit as we're in the first quarter of this year.

The other factor you've got going on there is we see very strong demand in certain platforms. But as a result, there's also a lot of demand for material and that's in tight supply. And so with certain platforms where we see strong and consistent demand it's a little bit more challenging to find the used material to service that demand.

So -- in summary, I feel very good about MRO, feeling good about the continued recovery and growth in commercial parts distribution but a bit of an uneven story in trading based on the factors I just described.

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

Okay. That's helpful. And you've got a, obviously, very low leverage. It sounds like from your commentary that there might be some investment opportunities you're looking at -- you've talked in the past about attractiveness of PMA. Is that something you're continuing to look at?

And organically, are there -- is there an expectation that there's significant opportunities to invest in either engines or airframe or other feedstock as you think about the surplus marketplace here in the near term?

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

Yes. Great question. So -- in terms of feedstock and the trading business, that's one of our greatest strengths right now is our balance sheet capacity and our ability to move very quickly and outmaneuver the competition when packages or material become available.

And we are in the market all day, every day, around the world looking for the right material. And when we find it, we're able to close very, very quickly. So that will definitely be a source of capital deployment for us throughout the year.

As it relates to PMA and other initiatives specifically, we do have organic PMA efforts underway, and we're encouraged by the progress there. It's early and it's slow growing, but we do have a nice team focused on organic PMA efforts. And as we've indicated in the past, we will continue to look at inorganic opportunities to bolster that effort if assets become available and we can get valuation, et cetera, to align with expectations.

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

Okay. That's great. And if I could just -- one final question. As I look at then the investments, you had some nice growth in cash from obviously '21 through '22. How do we think about -- and you've got a lot of money tied up in working capital. So how do we think about free cash in '23 on top of just the growth in income? Is working capital maybe some opportunity to unlock some cash there? Or do we see limited growth of '22?

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

Yes. We're really proud of the consistent cash flow that we've been able to generate, and that goes along with the consistent margin improvement, et cetera, that we've been able to drive in the business overall. We certainly expect to be cash flow positive again this year, and our goal is to remain consistent in terms of cash flow generation.

Having said that, though, just going back to your prior question, if we see an opportunity to make a great purchase of hot engine material or feedstock to serve other parts of the trading business, we're going to deploy that cash and deploy it quickly. And again, that's an advantage of the market.

So while the goal, overall, is to continue to generate cash and continue to be more efficient with our working capital, we want to remain flexible so that we can react to market opportunities.

Operator

Our next question comes from Josh Sullivan with Benchmark.

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

Just on that comment there, the uneven story in the parts business, I think you said you saw an acceleration in Q3, Q4, then a moderation here. Is there any dichotomy you can identify between narrow-body and wide-body just as some of those markets come back here?

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

Yes. I'd say the unevenness is a bit from the -- is more from the narrow-body. Our wide-body business in trading is largely to support the cargo market. And that's been consistent throughout the pandemic and very, very strong. And those are the areas where we find the tightness in the supply of material.

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

And then just as far as the CFM56 relationship with Fortress, how is that performing? You mentioned hot section opportunities there? Do you see volumes picking up there, going forward?

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

Yes, that's a great question. That partnership continues to go extremely well. That has been a great source of material for us to serve that narrow-body market and Fortress is doing a really fine job on delivering the commitments to material to us that they made at the beginning of the agreement.

I mean, at this point, it's fully ramped up. And we continue to work with Fortress as they expand their business and their engine portfolio, we could see growth in that platform. But at this point, it's operating at full capacity and at the level we expected.

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

And then just on the investments you made in your labor pool throughout COVID. How much runway do you think you have before you need to reinvest? Or what level of traffic would you need to see where you said capacity?

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

On the -- in the MRO business?

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

Yes. Yes. I mean just in the great investments you guys made in keeping your count around how much capacity that is there.

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

Yes. So we -- again, thanks for highlighting that. I mean we're really proud of the way we held together the team through COVID, and that has served us very, very well. And it wasn't just holding the existing team, it was maintaining the partnerships that we form with schools over time.

We continue to fund those partnerships, and we continue to get results in terms of, I would say, a proprietary source of talent with these relationships we have with the schools to support the MRO business.

In certain markets, our capacity is limited by our ability to hire. And in other markets, our capacity is limited by [Foursquare]. In the markets where we're limited by Foursquare , we are considering opportunities to expand our footprint, where we know we've got supply of labor, and we know we're going to have longer customer interest.

So at this point, when we say the hangers are full, we mean full both in terms of footprint as well as labor availability. But as we move forward, we're going to again focus on some targeted expansion to look for ways to grow that business domestically.

Operator

We have a follow-up from Ken Herbert with RBC.

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

John, what should we assume for any kind of labor rate relief you might be getting in the MRO business in fiscal '23, considering the inflated labor costs?

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

Yes. Our goal right now is to preserve the margin gains that we have made. We've seen a lot of improvement in efficiency in that business over the last 18 months, and we want to hold on to that.

So as we see increasing labor costs, that is driving any discussions we're having with the customer about price adjustments. But the goal there is to preserve the spot that we're in. That has been a very dynamic environment over the last 3 or 4 quarters. I think we've mentioned that our customers, as you've heard from them, they're seeing the exact same labor pressures we are.

And so they recognize the value that we bring and the service that we provide to them and the need for us to be profitable and to be able to attract talent. So it's a challenging environment for everybody. But so far, we've been very pleased with the support we've gotten from the customer on the need to change prices to address rising labor costs.

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

Okay. That's helpful. And in the past, you've talked about the need to see a sort of a more material inflection in demand for surplus material in the revenues associated with the surplus parts market to really see a step change in the margin profile. It sounds like, from your comments, that we're maybe not there, at least in the first half of fiscal '23.

What should we be watching out in order to maybe get a little bit of visibility on that margin step change? And barring that, how should we think about the margin progression for fiscal '23?

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

Sure. So again, very proud of the progress that we made over the last 7 quarters on operating margin improvement. And as you know, we're now well exceeding, particularly with this configuration of businesses, well exceeding the margins that we had pre-COVID.

As we see the parts business recover, and you're right, we're not at that inflection point yet where we'll see a meaningful step up from where we are as we see that parts business recover and the overall revenue mix shift towards the parts businesses, we would see further margin expansion.

At this point, it's difficult to predict the trajectory of that. As you highlighted, I don't think we'll see that meaningful step change in the first half of the year. But as the supply chain issues or labor issues get worked out in the system and airlines can service the demand that they see and flying increases, we would expect parts business to pick up in the second half of the year.

Just to quantify that, our -- both in the trading and commercial parts distribution, overall down still about 20% from where we were pre-COVID. That compares to roughly 25% from where we were in Q3. So we have seen a modest improvement there, which contributed partially to the sequential margin improvement that we saw this quarter.

But given we're still 20% off of pre-COVID levels, we've got a ways to go in that business. And again, that would help margins throughout next year or this year.

Operator

Our next question comes from Michael Ciarmoli with Truist.

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

John, just on '23, I know you're not going to give the guidance, but if we went back to last quarter, you talked about this inflection, a more meaningful inflection in '23. Should we still be thinking about that?

And I guess, if I look at -- I mean, you just gave where we were on parts, but are we thinking that a return to peak commercial revenues occurs this year? Or -- I guess, how do you see '23? Should we still think about that meaningful inflection? Or how should we calibrate our expectations here?

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

Yes. I think -- great question. I go back to the prior comments in as much as we still see the potential for that, I think at this point, it's a second half discussion as opposed to a first half discussion.

And when we talk about getting back to pre-COVID peak revenues, keep in mind, we structurally took out revenue from the company from activities that weren't profitable or were unprofitable. And so really, in terms of getting back to pre-COVID levels, we're talking about parts businesses. And that's that kind of 20% off that I just described.

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

Got it. Got it. What -- as we think -- you said more second half -- and I mean, obviously, we're seeing the results from the airlines now. And I think if we looked at outside repairs by Delta, United, these guys are all spending significantly. What's sort of the dialogue?

You mentioned that the hangers are going to be full. I mean, I think we're all looking at potential global economic slowdown. Are you seeing any or hearing anything different from your customers about how they're thinking about their longer-term planning for their fleets?

Certainly, it doesn't seem like there's any potential pullback in maintenance at this point, but any kind of color you're getting from the airlines as they think about their longer-term planning?

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

I think, overall, the airlines remain bullish on the return of demand. And we believe that the current generation of fleet based on what we're hearing, which is the fleet that we're predominantly involved in endorsing is still going to be around for longer than people initially expected.

So that bodes well for us. I think the challenge for the customers -- for our customers right now is really, as you've heard from them, it's driven by the staffing challenges that the airports themselves, pilot shortages, which have caused them to have to cancel flights and fly less.

That's really their focus. But overall demand for air travel that we're hearing from our customers still remains very, very strong. It's just about getting the system back up fully running, so that we can actually support that demand.

And so again, while we're kind of in a bit of an uneven period here, we still feel really good about that return of the parts business and the fact that the platforms in which we operate and perform maintenance on that they're going to be around for a long time.

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

Okay. Got it. That's helpful. And then just 1 last one. You mentioned -- and you've had a press release, I believe, out on it. The Aero Design Labs, I mean you actually said you made some investment there. And if I go back, and I don't know, it's maybe 15 years or so, they're kind of comparing this to winglets and the opportunity that, that presented, which really significant for a lot of the aftermarket players.

So I mean, do you see the same potential in the 737 drag kit? I mean is that -- and maybe if you could just elaborate on the investment you made in sort of how you guys are thinking about the model for revenues and sort of the opportunity there for these kind of retrofits, if you would?

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

Yes, I think you've hit it on the head. I would definitely say that this is analogous to winglets. We're excited that they announced the STC on the 737-700, and we know they're working on the same for the 737-800 and 737-900, which obviously is a very large fleet. And given the price of fuel today, we expect that the airline community interest will be extremely strong in this solution. We were really happy to get -- to start this partnership very early with ADL.

We've actually been working with them for some time. And we have increased our investment in the company over that period of time. So we're very bullish, both from an investment standpoint but also as it relates to the exclusive agreement that we've got in place to distribute the kits as they're developed and produced.

Operator

And I'm showing no other questions in the queue. I'd like to turn the call back to AAR for closing remarks.

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

Great. Once again, I really appreciate everybody's time and interest in the support and we look forward to reporting on our first quarter. Thank you very much.

Operator

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