CAE Inc. (TSX:CAE) Continues to Surprise

Description

CAE Inc. (TSX:CAE)(NYSE:CAE) announced fourth-quarter earnings May 25 that were $0.05 better than analyst expectations. As a result, its stock hit an all-time high of $27.10 a a share.

I've liked the maker of flight simulators for a while now, but I only recommended it in early April as part of a trifecta of stocks to buy for the same price investors would pay for **Spotify Technology S.A.** (NYSE:SPOT), the music streaming service that went public April 3 to great fanfare.

The biggest tailwind CAE is benefiting from at the moment is a chronic shortage of qualified pilots to fly the increasing number of aircraft being pushed into service to meet a global thirst for travel. It's virtually unquenchable.

At the time of the recommendation, I'd highlighted the fact that CAE stock hasn't had a down year since 2011; it's up 15% year to date through the first five months of 2018, and it has a solid fourth quarter under its belt, so I doubt CAE stock is going to lose much altitude in the coming quarters.

Positive steps were taken in Q4 2017

Raymond James analyst Ben Cherniavsky wasn't expecting CAE to deliver fourth-quarter earnings per share of $0.37, $0.06 higher than his estimate for the quarter.

"One quarter, of course, does not make a trend, and we recall that this strong beat follows a couple of misses that CAE reported earlier this year," the analyst said in a note to clients. "Still it is worth noting that a number of the key factors that have been issues for us with this story … moved markedly in the right direction last quarter."

Issue #1

CAE's civil aviation business generates 58% of the company's overall revenue. As it goes, so goes CAE. In Q4 2018, its civil aviation business had an operating margin of 21.0% — 200 basis points higher than a year earlier, driven by a 14.2% year-over-year increase in its operating income.

Overall, CAE's operating margins in the fourth quarter increased 440 basis points year over year to 18.1%. On a sequential basis, CAE's operating margins increased by 210 basis points. The company's operating margins haven't been this high since 2012.

Issue #2

Excluding one-time items, CAE's return on capital employed in fiscal 2018 was 12.3%, 110 basis points higher than a year earlier. Again, the company hasn't seen profitability like this since 2012.

Free cash flow, which Cherniavsky has been keeping an eye on, was $288.9 million in 2018, 12% lower than a year earlier. However, if you consider that it's still the second-best showing over the past decade, I don't think you should hold that against CAE, especially since it has a $7.8 billion backlog as of the end of March.

The bottom line on CAE continuing to surprise

Fool contributor Ambrose O'Callaghan mentioned recently that the company has won some defence orders in fiscal 2018, including a maintenance training solution with the Royal Canadian Air Force which will generate an estimated $300 million over the next 26 years.

CAE might be trading at or near an all-time high, but with all three operating segments running at full speed, it's hard to see it slowing down over the next 12-24 months.

Cherniavsky sees 2020 EPS of $1.40 a share, which means despite its all-time high, CAE is only trading at 19 times its forward earnings. If margins keep going higher, the analyst is going to have to raise his 12-month target price, which is currently below where it's trading.

He's a little skeptical. I'm not. CAE's got legs.

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