UNEDITED TRANSCRIPT
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<<Kenneth Herbert, Analyst, Canaccord Genuity Group, Inc.>>

All right. We'll go ahead and get started. My name is Ken Herbert, I'm the aerospace and defense analyst with Canaccord Genuity. And appreciate everybody sticking around on a Thursday, second day afternoon. Very pleased to have management of Cubic Corporation with us today. Just to my left, we've got Brad Feldmann, Chairman, President and CEO; and Anshooman Aga, the Chief Financial Officer and Vice President. Correct? And I would just make a quick comment that somewhere in one of those big books floating around, there's the necessary disclosures and everything else. So just make a reference to that. And we're going run this like a fireside chat format and we'll then put it up at the end, have a few minutes, certainly for some Q&A.

But Brad, let me just start off with – I think most people in here probably there's a high level of familiarity with the company. But if you could just give just a minute on the company and then some more of the sort of high level trends I would say we're seeing today in your transportation and defense markets.

<<Bradley H. Feldmann, Chairman, President and Chief Executive Officer>>

Thank you very much.

<<Kenneth Herbert, Analyst, Canaccord Genuity Group, Inc.>>

Yes.

<<Bradley H. Feldmann, Chairman, President and Chief Executive Officer>>

Thanks for being with us today. We use four words to describe the company. Those are technology driven market leading. So all of our businesses, we need to invent new things to help our customers and we need to do it faster than our competitors. And then market leading. We want to be in businesses where we have a market leadership position or a path to do that.

We have three lines of business. One is transportation. We're known for collecting fares in major cities. If you think about the Oyster card in the system for doing that in the back office and so forth, we had the privilege of interacting with 15 million people a day. And we have 70% patron share in the United Kingdom, North America and Australia. So it's a very good business for us.

We have a legacy defense business that is a training business. We – believe it or not, invented the top gun system in the early 70's and had the privilege of training fighter pilots in the United States and around the world. We do similar kinds of training systems for the army as well as the navy and the Marine Corps. And then the third business is a business we've been growing through acquisition. It's a communications business that supports the movement primarily of full motion video post 911, we made a bet that there would be an insatiable appetite regarding full motion video. It used to be the way the structure worked at least in the U.S. the higher ups would get this kind of information in a counter – terrorism counter insurgency kind of warfare that we've been in the last n number of years. We wanted to provide that information to Sgt. Jones.

And so, we've made a number of investments, half a dozen or so kinds of things. And that business about five years ago was a $40 million business breakeven and through three quarters, we're above $200 million. Last year it was at $197 million, so there's obviously going to be good growth and very good margin. In terms of trends, our business is focused in transport on mass transit. And that's very helpful. Of course in reducing congestion in cities, we see more and more people moving to cities. So we don't see mass transit going away.

And when we think about expanding our business, we think about moving from purely payment to payment and information technology across all the modes of transport to reduce congestion. In the defense training piece, we need to improve our operational readiness and of course, around the planet, pieces not broken out. And in a large sense, it's a much more complex world than it was say, 10 years ago. And in our C4ISR business, mission solutions business, there's this insatiable appetite for full motion video. There's this idea of fusing all kinds of datasets together, so people can make better decisions so that forces can be effective.

<<Kenneth Herbert, Analyst, Canaccord Genuity Group, Inc.>>

Thanks Brad for that review. Let's just start in your transportation business. You've got some very high profile contracts going both here in Boston and New York City, other parts of the world. On your most recent fiscal third quarter call, you highlighted maybe a few issues on the Boston side and just ensuring that your customer is completely happy with how they roll that system out. Can you give an update on those two projects in particular and some of the future or near-term milestones we should be looking forward to?

<<Bradley H. Feldmann, Chairman, President and Chief Executive Officer>>

Yes. So I'll start out in New York. New York was the first contract we won last year. By the way, we're very fortunate, last fiscal year, in the first quarter we won New York, in the second quarter we won Boston, in the third quarter we won Brisbane and in the fourth quarter we won San Francisco, so quite a run. And as a result of that and other activities within the company, the effect of backlog of the company increased from $2.4 billion to $4.8 billion in one year. So we're very proud of that. Our team did extraordinary work.

We delivered the first milestone in New York City on 31 May. It was called beneficial use one. There were a couple of lines of the subway as well as all the buses in Staten Island, where we put new readers on as well as the new back office. And so our team is very proud of that. Future milestones occur around Thanksgiving time and go over a couple of years. We greatly bought down the risk, if you will, of that project delivering the kernel of capability. Folks in New York are very happy and we're very proud of our partnership with the MTA.

Turning to Boston, that was one in the second quarter. We're still in the design phase and our customer wants to change how some of the milestones are done based on the population different equipment sets, how to deal with the retail network and the like. So we're in friendly negotiations working, but our team is working full steam ahead. Things are going well. We're going to change some of the interim milestones on the project.

Brisbane is ramping up. And that's going extremely well as well as San Francisco. The reader that we developed in New York is a common reader for all of those properties. And in fact, we frozen the designs on that and we're buying material for all of those properties in a prudent way, getting a good bundling discounts I might add. And that will drive a revenue and margin. So we're doing very well and our team, we're very proud of what our team is doing and very happy with the partnerships we have with our customers.

<<Kenneth Herbert, Analyst, Canaccord Genuity Group, Inc.>>

So one of the things – I just wanted to follow-up, one of the things you mentioned and maybe to pull Anshooman on this as well as, I think there was a healthy amount of skepticism around the margin opportunities. You've talked over the last few years around productization within CTS, around some of the shared services and ERP and other investments you've made. I think we are starting to see that in the margins you put up and as we get closer to next year. Can you just talk through sort of your level of success or comfort with some of those investments and the returns you're getting on them around that and then what that might mean moving forward as we think about margins within the segment.

<<Bradley H. Feldmann, Chairman, President and Chief Executive Officer>>

So I'll just provide some broad context and I'll let our CFO talk about margins. So I've been at this about five years. When I was fortunate takeover I'd been in the company at five years at that point. We had 110 disparate IT systems. That's like really expensive to run. And we moved everyone to SAP. We had seven supply chains and we're not bundling buys. We now have one supply chain and we're bundling buys. We have seven factories and we've whittled that down to three factories. And so we had zero analytics. We were very much a paper-driven. And so we're working very hard on analytics and dashboards and the things that modern companies have. And so all of those things, if you will, are improving our efficiency and improving our collaboration in saving us money and all.

<<Anshooman Aga, Executive Vice President and Chief Financial Officer>>

Yes. So all of this translates into higher margins for us in the business, if you go back to 2017, we were served 8% adjusted EBITDA margins on sales. We increased by almost a 100 basis points last year. And this year, midpoint of guidance has a little over 10%. And our goal for 2020 guidance is 11% to 12.5%. So it's not a promise at the end of the journey. It's a continuous step up that we've been having every year and then delivering higher margin. All of that along with some of the productization which, Ken mentioned on the CTS side, if we look at our Q3 margins in CTS, they're higher than Q1 and Q2 and higher than all the last fiscal year. So good progress and while we've been investing in a lot of these back office to improve margins, we've also been increasing our spent on innovation and R&D and our overall EBITDA margins are going up despite all of that.

<<Kenneth Herbert, Analyst, Canaccord Genuity Group, Inc.>>

One of the questions I get as well as, you're playing in markets when you think about payment processing within in transportation. And I think a lot of us buy into the urbanization congestion opportunities and what it creates. I know two questions here really. The first is, you are obviously as you mentioned Brad, broadening out into other opportunities around surface transportation and things like that with GRIDSMART and Trafficware another acquisitions, but then second you also have this perceived or real sort of existential threat as you think about larger companies, Uber, Google, Apple that clearly are looking at similar markets. When you think about transportation and infrastructure and maybe just address those points around your sort of push into other markets, but then also the moat at you've built around this business and how we should think about defensibility of that moat.

<<Bradley H. Feldmann, Chairman, President and Chief Executive Officer>>

Yeah. So I think, if you think about, again, large cities mass transit is not going away. As I mentioned, the patron share we have is very high. In fact, in the U.S., we have nine of the 10 top cities in the U.S. And in all of those areas, there was a turnstile and there was a reader and that technology for that reader is ours and the back office is ours. And so you can be existential, whatever and you're not going to be able to read that interface with that reader and you're not going to be able to interface with that back office

And so our thought is to build from mass transit out and add all these other modes. So lot of these existential, whatever you call them, we'll be partners and we will add their functionality to the mass transit ecosystem. And in fact, as you know, we announced partnership with Apple few quarters ago and you could just connect the dots.

<<Kenneth Herbert, Analyst, Canaccord Genuity Group, Inc.>>

Yeah. Okay. That's great. And so as you look at – as we think about the pushing out into other parts from mass transit. Any way you can talk about what that market might represents in terms of addressable market or sort of adoption or penetration into some of these other markets?

<<Bradley H. Feldmann, Chairman, President and Chief Executive Officer>>

Yeah. So, as we move these concentric circles out, that of course gives us a larger addressable market. The automated fair collection market itself is single digit billions, as you add these other kinds of things it doubles roughly the addressable market. The thing that we're real keen about, which we'll talk about in some detail on our next call, is this idea of a digital pivot. And so one of the things that we're really good at is, collecting the data, moving the data, computing with the data. Then there's modeling and simulation algorithm, data visualization, cyber and power management. And I would argue that we're less good, "at using the data that help our customers make great decisions"

So one of the moves, that we were public about, we hired a Chief Digital Officer away from IBM, and so he and I and others are working at trying to create digital platforms. Platforms that we can scale, and when you scale them of course in the cloud, you can have multi-tenants and as a result of that, they're adding extra customers, the cost is nil to do that, yet the revenue function would go up much faster.

And so, we think in the middle market in particular, customers that don't have a lot of CapEx,
if you will like New York for instance. But they have OpEx, they get money each and every journey that's taken in. We believe that we will have the ability to provide an offering. We believe we'll be able to scale that and there'll be a change in terms of augmenting our business model that will have platform economics. So that's one of the things we're working on. And that will change the game in terms of margin expansion.

<<Anshooman Aga, Executive Vice President and Chief Financial Officer>>

It seems like that kind of model would provide much more of a recurring software type, maybe not software gross margins, but phenomenal opportunities.

<<Kenneth Herbert, Analyst, Canaccord Genuity Group, Inc.>>

Good. We'll watch out for more on that front. Let's just turn over to the defense side of the business for a couple of minutes. I think lots of peoples were intrigued by this Pixia investment you announced with your most recent results. Obviously ties in very well with your initial comments on – at the edge in terms of your ability and the information flow and requirements there. Maybe a little bit more detail on what that brings to you specifically and how we should think about your end of year option time horizon to maybe buy the whole company.

<<Bradley H. Feldmann, Chairman, President and Chief Executive Officer>>

Yeah. So I'll talk about the capabilities and I'll let Anshooman talk about the optionality and all of that. The reason we were intrigued with the company, I talked about the notion of insatiable appetite for full motion video. So full motion video we're kind of watching what people are doing, but it's sort of like a little soda straw watching this small little area. What Pixia provides is, they're great and retrievals information geo spatially very quickly. They also have been processing something called wide area motion imagery.

And so when you think of whammy, it's a whole area, a much larger area. And the way these things tend to work as people look at a whole area, they understand things that they're interested in and then they put this soda straw on it. So you can kind of see how these two datasets will allow Defense Department and the like to see patterns and so forth. So, their technology is not only applicable at enterprise level, but we also think will be applicable at the edge as we have secure clouds on the edge and we'll increase the speed of processing. And by the way, there are some very key customers that we would like to be in and we believe there will be revenues synergies as we use those sales channels. So, we're thrilled to partner with them. I'll turn the optionality over to my CFO friend.

<<Anshooman Aga, Executive Vice President and Chief Financial Officer>>

Yes. So Ken, this business is first of all a great business. It's software platform margins already the revenue is growing, the profitability as a result is growing well and the multiple we paid is that pretty attractive and a slight discount to what the AND multiples are in the market. We think of it we're engaged and living together before the marriage. We have a few things to figure out before. We have to deliver our Q4 results, which gives us the capacity to go do the deal with issuing debt. We'll obviously work together in the timeframe and by the end of December, we have to exercise the option and close by the middle of February.

<<Kenneth Herbert, Analyst, Canaccord Genuity Group, Inc.>>

As you look now at your portfolio, within the defense business in particular, within on the mission solutions side in particular, are there still any obvious opportunities or holes in your portfolio? I know you've done a lot to build this business over the last five years?

<<Bradley H. Feldmann, Chairman, President and Chief Executive Officer>>

Yes. I mean, we have a view – a very wide view on what we can do. We look at submarkets and look at option value for these things. And so there's always things that we could add. But again, those four words drive us technology-driven market leading. So, it has to be the best in the piece of functionality that's added. But the company is doing quite well. Last year, the revenue of that business, by the way four years ago, it was $40 million through Q3; it was north of $200 million. And last year, it did $197 million. So, we probably grew last year it seems and so the business is doing terrific. And we commented a few quarters ago, these businesses that we bought are growing 30%. So, really good economics on these businesses. So, we’re very glad to have them within the Cubic family.

<<Kenneth Herbert, Analyst, Canaccord Genuity Group, Inc.>>

No, it looks – I think the guidance implies a pretty robust fourth quarter, but you obviously seem pretty confident on what’s in the backlog and visibility there? High level within the defense side, can you just further comment on with the two-year budget agreement and does that maybe help with some of the cadence or level setting amongst the quarters and maybe take some of the fourth quarter hockey stick, out of your numbers or other benefits of that?

<<Bradley H. Feldmann, Chairman, President and Chief Executive Officer>>

I think there’ll be some movements have been left. I think there will be regular order in the defense budget. I believe with this budget deal, I think when Congress comes back; they’ll work, day and night, day and night to have a budget by 30 September. And so what that allows is ordering sooner. These are program of record kinds of things and things that are in very high demand. And so that will allow ordering sooner, which will move revenue to the left in time. And then on top of it with the immense backlog we have, particularly in transport, I mean, we’re already working at ramping up Brisbane and San Francisco, which have had some revenue this year, but still have much more next year.

<<Kenneth Herbert, Analyst, Canaccord Genuity Group, Inc.>>

Yes. Yes. Okay. And as I look at, just back to the transportation side, you obviously pretty much you just went through the four major wins you had in fiscal 2019 – I’m sorry, fiscal 2018 you talked about, I know on prior calls, sort of the opportunity moving forward. What’s – what are the next one or two big things, Brad, we should be watching out for either in transportation or on the defense services or CMS side?

<<Bradley H. Feldmann, Chairman, President and Chief Executive Officer>>

Yes. So, a couple things are book-to-bill ratio two years ago was north of 1.1; last year, it was north of 2.3. This year will be a little bit lower than one. We expect that. But some of the opportunities going forward, I mentioned on the call that we put in a bit in Singapore. Singapore is a customer of ours and we put in modern equipment and they want to match that equipment across the fleet. We also put a bid in the Hong Kong; they were a customer many, many years ago. And so there’s an opportunity there. We’re working hard on Toronto. We commented that we had one in Dublin and there’s more work going to follow that. We’ve been working in the middle market in Canada and we made some comments about that.

And then we mentioned four significant wins that we had in our data link group. We won the data link opportunity on the MH-60. We won the data link and SATCOM opportunity on the MQ-25. We won the data link opportunity on the F-35 and we won a data link opportunity on a small form factor radio that has an anti-gym waveform called Boomslang. And we think that Boomslang waveform is terrific. And so this will lead to growth as these are franchise kinds of wins. And so a lot of what we've done is in backlog and these things will put miracle grow on them and they will grow seeing franchise wins.

<<Kenneth Herbert, Analyst, Canaccord Genuity Group, Inc.>>

And just finally, then and I'll put it up to the audience in a second, but phenomenal growth – phenomenal growth in backlog, a lot of wins. How do we think about and it looks like there's good visibility on the margins, but I'll just ask sort of the obligatory question on cash generation and the time period and sort of the conversion of the EBITDA to cash and how we should think about that framework over the next couple of years, because you've clearly been investing a lot in the business.

<<Bradley H. Feldmann, Chairman, President and Chief Executive Officer>>

We've been investing a lot in the business and these big programs usually start off using working capital as we're doing the engineering and a lot of the software in the back office. Customers usually like to pay milestone tied to hardware delivery. So, the initial part of the projects we burned cash and then we get the cash back during the second stage of the project execution. So, being a project business, it's probably better to think of our cash flow in two or three-year increments. And if you think of a three-year increment, we should be converting our net income equal to cash, going forward.

<<Kenneth Herbert, Analyst, Canaccord Genuity Group, Inc.>>

Any questions from out of the audience?

<<Bradley H. Feldmann, Chairman, President and Chief Executive Officer>>

Well, we have a question.

<<Kenneth Herbert, Analyst, Canaccord Genuity Group, Inc.>>

Yes. Sorry, go ahead.

Q&A

<Q>: [Question Inaudible]

<A – Bradley H. Feldmann>: Yes. So, Pixia is a geospatial processing and retrieval company. Yes. There are potential applications in our ticketing business. We're exploring that now. But that wasn't the primary piece of the valuation thesis to be clear. Yes.

<Q>: [Question Inaudible]

<A – Bradley H. Feldmann>: It is. We invented it.

<Q>: [Question Inaudible]

<A – Bradley H. Feldmann>: Early days – yes, but early days. What we are doing in that market by the way is we've developed a gateway between sort of pushed to talk devices and shell infrastructure under the FirstNet program. And we're actually the exclusive provider for these gateways to both Verizon as well as AT&T. And so we're starting to see sales move with that.

<<Kenneth Herbert, Analyst, Canaccord Genuity Group, Inc.>>

Excellent. All right. Well, with that Brad, Anshooman, thank you very much, and Kirsten as well. And guys, have a great afternoon.

<<Bradley H. Feldmann, Chairman, President and Chief Executive Officer>>

Ken, thank you.